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Audited Financial Statements

**Kentucky Higher Education Assistance Authority**

June 30, 2004

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<b>Report of Independent Accountants .....</b>	<b>1</b>
<b>Management's Discussion and Analysis (Unaudited) .....</b>	<b>3</b>
<b>Financial Statements</b>	
Government-Wide Statement of Net Assets .....	14
Government-Wide Statement of Activities .....	15
Statement of Net Assets – Proprietary Funds .....	16
Statement of Revenues, Expenditures and Changes in Net Assets – Proprietary Funds .....	17
Statement of Cash Flows – Proprietary Funds .....	18
Balance Sheet – Governmental Fund .....	20
Statement of Revenues, Expenditures and Changes in Fund Balance – Governmental Fund .....	21
Statement of Fiduciary Net Assets (Deficit) .....	22
Statement of Changes in Fiduciary Net Assets (Deficit) .....	23
Notes to Financial Statements .....	24

## Report of Independent Accountants



Board of Directors  
Kentucky Higher Education Assistance Authority  
Frankfort, Kentucky

We have audited the accompanying financial statements of the governmental activities, the business-type activities and each major fund and the aggregate remaining fund information of the Kentucky Higher Education Assistance Authority (the Authority) as of and for the year ended June 30, 2004, which collectively comprise the Authority's basic financial statements as listed in the accompanying table of contents. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of Kentucky Education Savings Plan Trust, which statements reflect total assets of \$52,472,982 as of June 30, 2004, and total additions to fiduciary net assets of \$18,044,668 for the year ended June 30, 2004. Those statements were audited by other auditors whose reports thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Kentucky Education Savings Plan Trust, is solely based on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information of the Authority, as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 17, 2004, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 13, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

*Stathm & Company PSC*

Louisville, Kentucky  
September 17, 2004



## Management's Discussion and Analysis (Unaudited)

### Kentucky Higher Education Assistance Authority

June 30, 2004

#### Description of the Business

The Kentucky Higher Education Assistance Authority (the Authority) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. To that end, the Authority guarantees Federal Family Education Loan Program (FFELP) loans; makes student loans directly to parents and students, purchases and services eligible student loans, and performs servicing and collection activities on eligible student loans for third-party lenders through the Kentucky Higher Education Student Loan Corporation (the Corporation); offers investment opportunities to help Kentuckians save for future higher education expenses through the Kentucky Education Savings Plan Trust (the Trust); and offers Kentuckians an opportunity to pay future tuition and related expenses at reduced present-value rates through Kentucky's Affordable Prepaid Tuition Plan (the Plan).

In November 1978, the Authority commenced guaranteeing student loans as the designated guarantee agency for the Commonwealth of Kentucky pursuant to the Federal Higher Education Act (the Act) of 1965, as amended. On July 1, 1996, the Authority was designated by the U. S. Department of Education (USDE) as the guarantee agency for the State of Alabama. As such, with regard to eligible student loans originated by the State of Alabama, the Authority is responsible for issuing loan insurance, providing assistance to lenders and lender servicers, paying lender claims, and collecting defaulted loans on which claims have been paid.

The Higher Education Amendments of 1998 (the 1998 Amendments) that were enacted on October 7, 1998, with an effective date of October 1, 1998, changed the manner in which FFELP is administered. Under the 1998 Amendments, the Authority established a Federal Student Loan Reserve Fund (FSLRF) and an Agency Operating Fund (AOF).

The FSLRF assets and all earnings on those assets are the property of the federal government. The funds in the newly established FSLRF are used to pay for reimbursements to lenders for defaulted student loan claims, pay the AOF for default aversion fees, and pay any Account Maintenance Fee (AMF) and Loan Processing and Issuance Fee (LPIF) due to the USDE when federal funds are unavailable. Funds used to pay loan claims are replenished from reimbursements from the federal government. The FSLRF also receives a rebate of default aversion fees paid if a default claim is paid.

The AOF holds and accounts for funds, controlled by the Authority, which are restricted for student aid and related activities. Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees, AMF (.10% of Original Principal Outstanding), LPIF (.40% of loans guaranteed and disbursed), and loan and lender servicing fees. Expenditures from the AOF include personnel, professional, administrative expenses, and rebates of default aversion fees paid if a default claim is paid.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Description of the Business--Continued**

In addition to the funds established by the 1998 amendments to the Act, the Authority administers eight major state-sponsored grant and scholarship programs and provides higher education outreach activities. Fund established to administer these programs (Student Aid Fund) is maintained with the State Treasurer. Sources of monies to the Student Aid Fund include General Fund appropriations, federal awards, lottery net revenues, and transfers from the AOF and the Corporation. Uses of funds include state grant and scholarship awards, personnel, professional, and other administrative expenses directly related to the administration of the student aid programs and outreach activities.

In 1978, the Kentucky General Assembly created the Corporation as an independent *de jure* municipal corporation. The Corporation functions as a lender of student loans, making loans to parent and students directly; a servicer of student loans; and a secondary market for the purchase of student loans from other lenders. The Corporation funds the origination or acquisition of these student loans by periodically issuing bonds and notes under various debt agreements, including its two general bond resolutions. The Corporation also services education loans and collects defaulted education loans. The Corporation's services and loans are marketed under the registered service mark "The Student Loan People<sup>SM</sup>".

The Authority is also charged with managing the Trust, an Internal Revenue Service Code 529 plan, which was created by the 1988 Kentucky General Assembly to help people save for the cost of education after high school. The Authority's Board of Directors administers the Trust and is managed by TIAA-CREF Tuition Financing, Inc. (TFI).

In fiscal year 2004, the Authority had governance control over the Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition, or KAPT, (the Plan). The Plan was created by the 2000 Kentucky General Assembly, and oversight was transferred to the Authority in the 2003 budget bill (House Bill 269). Upon expiration of the 2003 budget bill on June 30, 2004, the Plan was transferred back to a separate board of directors on July 2004. The Plan is an Internal Revenue Service Code 529 plan, which allows participants to purchase future tuition at reduced present value rates

The FSLRF, the Agency Fund (used to account for loan proceeds handled by the Authority on behalf of lenders and schools), the Trust, and the Plan are accounted for as Fiduciary Funds. The AOF and the Internal Service Fund (an administrative fund held by the State Treasury) are accounted for as Proprietary Funds. The Governmental Fund is comprised of assets maintained for grant and scholarship program benefits.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Overview of Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements are comprised of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to financial statements. This report contains other supplementary information in addition to the basic financial statements.

The government-wide statement of net assets and statement of activities include the Governmental Funds and Propriety Funds. The government-wide financial statements can be found on pages 14-15 of this report. The fund financial statements can be found on pages 16-21 of this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the Authority. Fiduciary funds are not reflected in the government-wide financial statements because the resources are not available to support the Authority's programs. The fiduciary fund statement of net assets (deficit) and changes in fiduciary net assets (deficit) can be found on pages 22-23 of this report.

The Corporation, the Plan and the Trust each published separate financial statements and footnotes. To obtain a copy of the financial statements and footnotes, please contact the Authority at (502) 696-7421.

Following is a condensed summary of financial information for the years ended June 30, 2004, and 2003, respectively.

Condensed Financial Information - Governmental Fund and Proprietary Funds

Kentucky Higher Education Assistance Authority

	Governmental Fund		Proprietary Funds	
	2004	2003	2004	2003
<b>Net Asset Information</b>				
Capital assets			\$ 14,967,294	\$ 14,705,092
Other assets	\$ 14,077,436	\$ 14,106,342	1,196,121,861	1,155,679,875
<b>Total Assets</b>	<b>14,077,436</b>	<b>14,106,342</b>	<b>1,211,089,155</b>	<b>1,170,384,967</b>
Long-term liabilities			975,477,839	1,033,265,782
Other liabilities	237,520	175,784	108,584,818	29,643,034
<b>Total Liabilities</b>	<b>237,520</b>	<b>175,784</b>	<b>1,084,062,657</b>	<b>1,062,908,816</b>
Net assets invested in capital, net of debt			7,221,663	7,190,717
Unrestricted net assets			11,954,893	11,355,470
Restricted net assets	13,839,916	13,930,558	107,849,942	88,929,964
<b>Total Net Assets</b>	<b>\$13,839,916</b>	<b>\$13,930,558</b>	<b>\$127,026,498</b>	<b>\$107,476,151</b>
<b>Activity Information</b>				
Interest and investment income	\$ 222,810	\$ 205,090	\$ 1,934,637	\$ 3,953,034
State General Fund revenue	70,843,693	45,860,000		
Student Aid and Advancement Fund revenue	72,745,982	58,546,800		
Federal funds revenue	1,157,936	817,800		
Tobacco Settlement revenue	750,000	570,488		
Service fees			19,487,790	5,475,187
Debt recovery commission			10,427,041	10,090,693
Federal fees earned			7,086,395	6,580,179
Default aversion fee income			1,450,689	863,793
Interest income on loans			61,455,867	38,595,613
Federal Student Loan Reserve Fund transfer				1,473,023
Other income	747,651	537,210	152,463	218,111
<b>Total Revenues</b>	<b>146,468,072</b>	<b>106,537,388</b>	<b>101,994,882</b>	<b>67,249,633</b>
Kentucky Tuition Grant	23,640,343	15,835,333		
College Access Program Grant	46,098,392	36,807,194		
Early Childhood Development Scholarship	833,131	764,460		
National Guard Tuition Award	2,621,895	2,251,589		
Kentucky Educational Excellence Scholarship	73,251,730	58,819,668		
Teacher Scholarship	734,410	3,755,771		
Osteopathic Medicine Scholarship	3,524,248	104,470		
Work-Study	988,521	997,674		
Outreach and other activities	830,751	749,493		
Guarantee operations			5,352,889	5,513,436
Default collection operations			5,392,256	6,022,219
Lender assistance operations			3,274,270	2,722,152
Lending and related activities			62,220,539	40,796,039
Other activities			120,738	
<b>Total Expenditures</b>	<b>152,523,421</b>	<b>120,085,652</b>	<b>76,360,692</b>	<b>55,053,846</b>
<b>Change in Net Assets Before Operating Transfers</b>	<b>(6,055,349)</b>	<b>(13,548,264)</b>	<b>25,634,190</b>	<b>12,195,787</b>
Interfund transfer	2,964,707	2,520,477	(2,964,707)	(2,520,477)
Transfer to KAPT			(119,136)	
Transfer to Governmental Fund	3,000,000	3,000,000	(3,000,000)	(3,000,000)
<b>Change in Net Assets</b>	<b>\$ (90,642)</b>	<b>\$ (8,027,787)</b>	<b>\$ 19,550,347</b>	<b>\$ 6,675,310</b>



Condensed Financial Information - Fiduciary Funds

Kentucky Higher Education Assistance Authority

	Federal Student Loan Reserve Fund		Agency Fund		Kentucky Affordable Prepaid Tuition		Kentucky Education Savings Plan Trust	
	2004	2003	2004	2003	2004	2003	2004	2003
<b>Net Asset Information</b>								
Capital assets		\$ 155,838	\$ 260,705	\$ 260,705				
Other assets	\$ 21,377,343	23,124,345			\$ 88,379,750	\$ 83,263,768	\$ 52,472,982	\$ 36,643,668
<b>Total Assets</b>	<b>21,377,343</b>	<b>23,280,183</b>	<b>260,705</b>	<b>260,705</b>	<b>88,379,750</b>	<b>83,263,768</b>	<b>52,472,982</b>	<b>36,643,668</b>
<b>Total Liabilities</b>	<b>6,306,848</b>	<b>7,431,386</b>	<b>260,705</b>	<b>260,705</b>	<b>100,269,073</b>	<b>92,877,135</b>	<b>76,607</b>	<b>100,813</b>
Net assets invested in capital, net of debt		220,090						
Restricted net assets (deficit)	15,070,495	18,629,284			(11,889,323)	(9,613,367)	52,396,375	36,542,855
<b>Total Net Assets</b>	<b>\$ 15,070,495</b>	<b>\$ 18,849,374</b>			<b>\$ (11,889,323)</b>	<b>\$ (9,613,367)</b>	<b>\$ 52,396,375</b>	<b>\$ 36,542,855</b>
<b>Changes in Fiduciary Net Asset Information</b>								
Federal reinsurance	\$ 43,821,009	\$ 52,823,599						
Contributions					\$ 2,256,417	\$ 35,025,146		
Subscriptions							\$ 12,700,472	\$ 11,167,545
Other income	409,947	1,146,465			7,972,494	3,215,957	5,344,196	1,664,847
<b>Total Additions</b>	<b>44,231,046</b>	<b>53,970,064</b>			<b>10,228,911</b>	<b>38,241,103</b>	<b>18,044,668</b>	<b>12,832,392</b>
Administrative expenses					728,895	1,399,983	295,439	
Refunds					354,616	254,316		
Trustee expense					139,901	97,402		
Tuition benefits					11,399,497	39,669,771		
Loan claims	45,715,095	54,386,453						
Redemptions							1,895,710	1,732,163
Default aversion	1,450,689	863,793						
Other expenses	779,889	498,172			1,094			
<b>Total Deductions</b>	<b>47,945,673</b>	<b>55,748,418</b>			<b>12,624,003</b>	<b>41,421,472</b>	<b>2,191,149</b>	<b>1,732,163</b>
<b>Change in Net Assets Before Operating Transfer</b>	<b>(3,714,627)</b>	<b>(1,778,354)</b>			<b>(2,395,092)</b>	<b>(3,180,369)</b>	<b>15,853,519</b>	<b>11,100,229</b>
<b>Operating Transfers</b>								
Transfer to Agency Operating Fund		(1,473,023)						
Transfer from Internal Service Fund					119,136			
Transfer to USDE for recall		(15,361,215)						
<b>Change in Net Assets After Operating Transfers</b>	<b>\$ (3,714,627)</b>	<b>\$ (18,612,592)</b>			<b>\$ (2,275,956)</b>	<b>\$ (3,180,369)</b>	<b>\$ 15,853,519</b>	<b>\$ 11,100,229</b>

## Management's Discussion and Analysis (Unaudited)--Continued

### Kentucky Higher Education Assistance Authority

June 30, 2004

#### Financial Analysis – Governmental and Proprietary Funds

This section of the Kentucky Higher Education Assistance Authority's (the Authority's) annual financial report presents a discussion and analysis of the Authority's government-wide performance for the fiscal year ended June 30, 2004. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, which follow this section.

#### Financial Overview

- The Authority's proprietary total assets increased approximately \$41 million, from \$1.170 billion to \$1.211 billion.
- The Authority's net student loans at year end were approximately \$979 million, an increase of approximately \$172 million or 21% over the prior year.
- The Authority's proprietary revenue for the fiscal year ended June 30, 2004, was \$102 million, an increase of \$34.8 million, or 52% over the prior year.
- The Authority's service fee income for the fiscal year ended June 30, 2004 was \$19.5 million, a \$14 million increase, or 255% over the prior year.
- The Authority's total lending and related activity expense was \$62.2 million for the fiscal year ended June 30, 2004, a \$21.4 million increase, or 52% over the prior year.
- The Authority provided approximately \$12.2 million in principal and interest on student loans, \$79.3 million in need-based grants and scholarships, and an additional \$73.3 million in merit-based scholarships.
- The Authority's change in net assets for the fiscal year ended June 30, 2004 was \$19.5 million, a \$12.8 million increase, 188% increase over the prior year.

#### Statement of Net Assets

Total Government Fund net assets decreased marginally, due to the net impact of the Authority maintaining additional cash and General Funds receivable in 2004 and reducing the conversion loan value in 2004. In fiscal year 2004, the Authority was instructed to carryforward funds for the Kentucky Tuition Grant (KTG) program. Accordingly, the Authority maintained \$2 million in KTG funds for use in fiscal year 2005. As of June 30, 2003, the Authority provided for a valuation allowance for conversion loans of \$1.9 million. In fiscal year 2004, the Authority increased the valuation allowance by \$2 million to \$3.9 million.

Continued



Management's Discussion and Analysis (Unaudited)--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Financial Analysis – Governmental and Proprietary Funds**

**Statement of Net Assets--Continued**

The increase in Proprietary Fund net assets are primarily due to the Authority's lending activities. Total assets grew from approximately \$1.170 billion at June 30, 2003, to \$1.211 billion at June 30, 2004. Net loans outstanding totaled \$979 million at June 30, 2003, a \$172 million increase over June 30, 2003. This increase included \$349 million in loan acquisitions (both originations and purchases) offset by borrower payments, consolidation loan payments, and principal forgiveness on loans. Other assets decreased by \$131 million as a result of improved cash management strategies which converted cash equivalents to loans and increases related to the Authority investing net proceeds from default collection operations. Total liabilities increased \$21.1 million. During the fiscal year the Authority drew down approximately a net \$41.3 million from its line of credit to acquire student loans. The amount was offset by approximately \$19.2 million in bond maturities. The Authority also refinanced a portion of the bond payable used to finance its office building, which resulted in additional debt of \$155,000. Accrued expenses increased approximately \$400,000 due to payroll timing, and the allowance for arbitrage decreased approximately \$700,000 due to borrower benefit programs. These increases were the largest components of the Authority's increase in total liabilities.

**Statement of Revenues, Expenditures and Changes in Fund Balance/Net Assets**

Government fund revenues increased substantially, 37%, due to increased funding from the Kentucky Lottery Corporation and additional general funds provided for the KTG program. In 1998, the Kentucky State Legislature created the KEES program and tied state lottery revenue to KEES and need-based scholarship and grant funding. In fiscal year 2003, the Authority received 64% of lottery net revenue. In fiscal year 2004, the Authority received 80% of lottery net revenue, a 25% increase over prior year. Additionally, the Authority received \$2 million of unclaimed lottery winnings to offset projected KEES under-funding. The General Assembly also provided \$5 million of general funds for the KTG program in fiscal year 2004; no such funds were available in fiscal year 2003.

Governmental expenditures also increased substantially, 27%, which is comprised of a 27% increase in direct benefits to students and 18% increase in administrative costs. Direct benefits increased primarily due to the increase in KEES awards (because the program is in the 6<sup>th</sup> year of an 8-year phase in process). The Kentucky Tuition Grant (KTG) and College Access Program (CAP) programs also noted increases in direct benefits (KTG increased 49% and CAP increased 25%). The increases in CAP and KTG resulted from increased lottery funds received and the \$5 million of general funds received. The Teacher Scholarship program did realized a \$3 million decrease in expenses from fiscal year 2004 compared to 2003.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Financial Analysis – Governmental and Proprietary Funds**

**Statement of Revenues, Expenditures and Changes in Fund Balance/Net Assets--Continued**

The Authority's proprietary fund experienced a 110% increase in changes in net assets before operating transfers, resulting from a 52% increase in revenue and a 39% increase in expenditures. Interest income increased 51% due to certain loans qualifying for the "minimum 9.5% yield" allowed under special allowance rules. The average yield from interest on loans in fiscal year 2004 was 6.74% versus 4.26% in fiscal year 2003. Given the declining interest rate environment, investment yields declined from 1.33% in fiscal year 2003 to .81% in fiscal year 2004. Service fee income increased due to the growth of a portfolio for a large client for whom the Authority performs third-party servicing activities. Debt recovery income increased because the new loan recovery processes implemented during fiscal year 2003, which started to show results in fiscal year 2004. Default aversion revenue increased because of the reduction in default claims. Federal fees revenue increased because of the increase in guarantee agency loan volume.

The increase in expenses was caused by the increase in personnel and administrative expenses net of the decrease in interest on debt. Operating expenses for lender and related activities increased 223% due to costs related to the growing loan portfolio as the Authority adds loan servicing volume. Lender assistance expense increased approximately 20% due to new loan proceed disbursement processes implemented in fiscal year 2004, while loan guarantee operations and default collection operating expenses both decreased, by a combined 7%. Interest on debt decreased by 20% due to declining interest rates on the variable rate bonds outstanding. Average rates declined from 1.87% in fiscal year 2003 to 1.32% in fiscal year 2004.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Financial Analysis – Fiduciary Funds**

This section of the Kentucky Higher Education Assistance Authority's (the Authority's) annual financial report presents a discussion and analysis of the Authority's fiduciary fund performance for the fiscal year ended June 30, 2004. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, which follow this section.

**Financial Overview**

- The Authority reduced default claims expenses in the Federal Student Loan Reserve Fund (FSLRF), from \$54.3 million in fiscal year 2003 to \$45.7 million in fiscal year 2004, a 16% decrease compared to the prior year.
- Contributions to the Kentucky Education Savings Plan Trust (the Trust) increased from \$11.1 million in fiscal year 2003 to \$12.7 million in fiscal year 2004, or 14% over the prior year.
- Interest and investment income in the Trust increased from \$1.6 million in fiscal year 2003 to \$5.3 million in fiscal year 2004, or 231% over the prior year.
- The Authority did not have an open enrollment period for Kentucky's Affordable Prepaid Tuition Plan (the Plan) in fiscal year 2004. Accordingly, contributions decreased from \$35 million in fiscal year 2003 to \$2.2 million in fiscal year 2004.
- Interest and investment income in the Plan increased from \$3.1 million to \$7.9 million, or 152% over the prior year.
- The Authority's change in net assets for the fiscal year ended June 30, 2004 was \$19.5 million, a \$12.8 million increase, 188% increase over the prior year.

**Statement of Fiduciary Net Assets (Deficit)**

The FSLRF assets decreased approximately 8%, while liabilities decreased approximately 15%. The decrease in assets is attributed to the decrease in federal reinsurance receivable as of June 30, which is due to the timing of payments from the federal government. As of June 30, 2003, the Authority had only one month of claim reimbursement outstanding. As of June 30, 2004, the Authority had two months of claim reimbursement outstanding. The additional decrease in total assets resulted from a decrease in investments, which resulted from the \$1.8 million reduction in net assets from loss on reinsurance and default aversion. The decrease in liabilities also resulted from the timing. As of June 30, 2003, the Authority had one month of defaulted loan collections payable to USDE. As of June 30, 2004, the Authority had two months outstanding.

Continued

## Management's Discussion and Analysis (Unaudited)--Continued

### Kentucky Higher Education Assistance Authority

June 30, 2004

#### Financial Analysis – Fiduciary Funds

##### Statement of Fiduciary Net Assets (Deficit)--Continued

The Agency Fund serves as a conduit for loan proceeds transacted between lenders and schools. The Authority usually only maintains Agency funds for lenders and schools for less than three business days. At June 30, 2003, the Authority maintained \$260,705 on behalf of schools and lenders. At June 30, 2004, the Authority maintained \$170,573 on behalf of lenders and borrowed \$419,339 from the AOF to send loan proceeds to schools. Under a new loan disbursement process, the Authority borrows funds from the AOF to advance disbursements to schools on the same day or next day of origination. All funds are received from lenders within one business day of disbursement. All Agency Fund payables and receivables were settled by July 1, 2004.

The Plan's total assets increased \$5.1 million, which resulted from an increase in investments of \$15.9 million net of a decrease in contributions receivable of \$10.8 million. Investments increased because of cash received of \$7 million from participants, investment income of \$7.8 million, and net contract income of \$1 million. The contributions receivable decreased because of the \$7 million received from participants and the \$3.8 million of cancelled contracts. The Plan liabilities increased \$7.4 million almost entirely from the increase in tuition benefits payable. The increase in tuition benefits payable resulted from current-year changes to actuarial assumptions for tuition increases, administrative costs, and investment income expense. Tuition increase assumptions in 2003 were 7.5% annually through June 30, 2008, and 6.5% annually thereafter. In 2004, the tuition increase assumptions were 7.5% annually through June 30, 2011, and 7.0% annually thereafter. In 2003, investment income was projected to be 7.25% (net of .25% investment expense). In 2004, investment income was projected at 7.76%; and investment expense was projected on a sliding scale of costs related to total assets at 49% of the first \$25 million, .28% of the next \$25 million, and .21% of assets in excess of \$50 million. Projected administrative expenses increased from \$1 million in 2003 to \$2.5 million in 2004.

The Trust is an Internal Revenue Code 529 plan managed by the Authority and administered on behalf of the Authority by TFI. Trust assets are entirely comprised of cash and pooled investments. Total assets increased approximately \$15.8 million due to new subscriptions received (\$12.7 million) and investment income (\$5.3 million), net of expenses and redemptions (\$2.2 million). Trust liabilities remained relatively constant during the fiscal year.

##### Changes in Fiduciary Net Assets (Deficit)

The FSLRF had a reduction in Fiduciary Net Assets of approximately \$3.7 million for the year ended June 30, 2004, which resulted from a decrease in default claims and a decrease in investment income. Loan claims expense decreased approximately 16% due primarily to the increase in default aversion activities performed by the Authority. Note that default aversion expense increased approximately \$700,000. The federal reinsurance decreased approximately 17% and has a direct correlation to loan claims expense (since the Authority files for federal reinsurance on all claims paid). The increase in loan claims expense (16%) did not match the increase in federal reinsurance (17%) because of claim mix (with varying reinsurance rates from 95%-100%).

Continued



Management's Discussion and Analysis (Unaudited)--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**Financial Analysis – Fiduciary Funds**

**Changes in Fiduciary Net Assets (Deficit)--Continued**

Investment income decreased from \$966,000 in fiscal year 2003 to \$66,000 in fiscal year 2004 because the Authority continued to move most of its investments to cash and cash equivalents to make sure cash reserves are sufficient to pay lender claims. Other expenses increased because, in fiscal year 2004 the Authority was required to pay a greater portion of the AMF "shortfall" from the FSLRF (\$602,173) in fiscal year 2004 than it paid in fiscal year 2003 (\$402,476).

Operating transfers changed significantly from the prior year. In fiscal year 2004, the Authority made no transfers to or from the FSLRF. In fiscal year 2003, the FSLRF transferred the federal recall money (\$15.3 million) to the U.S. Treasury as required by the 1997 Balanced Budget Act. The FSLRF also transferred to the AOF \$1.47 million, which represents investment income on the federal recall money. The \$1.47 million is restricted for default aversion activities.

The Plan recognized a negative change in net deficit of \$2.3 million for fiscal year 2004. The Plan had no enrollment period in fiscal year 2004, so no new contracts were sold. The Plan did receive contract income of \$2.2 million from participants in fiscal year 2004. The Plan also recognized \$7.9 million of investment income in fiscal year 2004, a \$4.7 million increase over the prior year. Administrative expenses decreased approximately \$500,000, from \$1.7 million to \$1.2 million. Administrative expenses decreased because the Plan incurred advertising costs in fiscal year 2003 in connection with the enrollment period and incurred almost no advertising costs in fiscal year 2004. While the Plan sold no contracts in fiscal year 2004, the tuition benefits expense did increase \$11.4 million due to changes in actuarial assumptions.

Trust activity in fiscal year 2004 continued its trend of improvement. In fiscal year 2002, the Trust recognized investment losses of \$1.8 million and interest income of only \$600,000 for a net loss of \$1.2 million. In fiscal year 2003, the Trust recognized investment gains of \$960,000 and interest income of \$700,000 totaling income of \$1.66 million. In fiscal year 2004, the Trust recognized investment gains and interest income of \$5.3 million. The improvement in investment activity resulted from improving market conditions starting in the fourth quarter of fiscal year 2003 through fiscal year 2004. Also, the Authority changed the investment options on January 17, 2004, from eleven age bands to six age bands. The Trust also experienced an increase in subscriptions from the prior year. The increase in subscriptions resulted from the Trust administrator, TFI, assigning a new account manager to the Trust. The new account manager has worked closely with the Authority to focus marketing resources toward increasing subscriptions. Redemptions remained relatively constant during the fiscal year.

## Government-Wide Statement of Net Assets

## Kentucky Higher Education Assistance Authority

June 30, 2004

ASSETS	Governmental Activities	Business-Type Activities	Total
<b>Current:</b>			
Cash and cash equivalents	\$ 1,620,523	\$ 82,757,299	\$ 84,377,822
Interfund receivable / payable	(32,189)	32,189	
Receivable from Federal Student Loan Reserve Fund		532,728	532,728
Receivable from Agency Fund		419,339	419,339
Accounts receivable	2,058,556	2,564,235	4,622,791
Special allowance receivable		13,655,293	13,655,293
Accrued interest income		16,729,440	16,729,440
Default aversion fees receivable		368,627	368,627
Investments		8,157,462	8,157,462
Teacher and Osteopathic Medicine Scholarship loans (current portion)	450,000		450,000
Other current assets	8,744		8,744
<b>Total Current Assets</b>	<b>4,105,634</b>	<b>125,216,612</b>	<b>129,322,246</b>
<b>Noncurrent:</b>			
Restricted cash and cash equivalents		60,169,108	60,169,108
Investments		12,980,997	12,980,997
Teacher and Osteopathic Medicine Scholarship loans	3,111,749		3,111,749
Teacher and Osteopathic Medicine Scholarship advances	6,860,053		6,860,053
Loans, net		978,578,931	978,578,931
Deferred loan purchase premiums and originations costs, net		14,295,902	14,295,902
Property and equipment, net		14,967,294	14,967,294
Deferred bond issuance costs, net		4,880,311	4,880,311
<b>Total Noncurrent Assets</b>	<b>9,971,802</b>	<b>1,085,872,543</b>	<b>1,095,844,345</b>
<b>Total Assets</b>	<b>14,077,436</b>	<b>1,211,089,155</b>	<b>1,225,166,591</b>
<b>LIABILITIES</b>			
<b>Current:</b>			
Accounts payable and accrued expenses	237,520	8,645,553	8,883,073
Accrued interest expense		1,389,265	1,389,265
Bonds/note payable (current portion)		98,550,000	98,550,000
<b>Total Current Liabilities</b>	<b>237,520</b>	<b>108,584,818</b>	<b>108,822,338</b>
<b>Noncurrent:</b>			
Allowance for arbitrage liabilities		20,492,839	20,492,839
Bonds/note payable		954,985,000	954,985,000
<b>Total Noncurrent Liabilities</b>		<b>975,477,839</b>	<b>975,477,839</b>
<b>Total Liabilities</b>	<b>237,520</b>	<b>1,084,062,657</b>	<b>1,084,300,177</b>
<b>NET ASSETS</b>			
Invested in capital assets, net of expended debt proceeds		7,221,663	7,221,663
Unrestricted		11,954,893	11,954,893
Restricted, other		86,061,379	86,061,379
Restricted for program benefits	13,839,916		13,839,916
Restricted for student aid and related activities		21,788,563	21,788,563
<b>Total Net Assets</b>	<b>\$ 13,839,916</b>	<b>\$ 127,026,498</b>	<b>\$ 140,866,414</b>

See Notes to Financial Statements



Government-Wide Statements of Activities

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

			Program Revenue		Net (Expenses) Revenues and Changes in Net Assets		
	Direct Expenses	Indirect Expenses	Charges for Services	Operating Grants and Contributions	Governmental Activities	Business-Type Activities	Total
<b>Functions/Programs</b>							
Governmental activities:							
Kentucky Tuition Grant	\$ 23,012,884	\$ 627,459		\$ 23,640,013	\$ (330)		\$ (330)
College Access Program Grant	45,420,182	678,210		44,352,880	(1,745,512)		(1,745,512)
Early Childhood Development Scholarship	771,342	61,789		802,245	(30,886)		(30,886)
National Guard Tuition Award	2,541,947	79,948		2,367,261	(254,634)		(254,634)
Kentucky Educational Excellence Scholarship	72,363,278	888,452		73,064,132	(187,598)		(187,598)
Teacher Scholarship	416,968	317,442		2,115,018	1,380,608		1,380,608
Osteopathic Medicine Scholarship	3,347,892	176,356		126,523	(3,397,725)		(3,397,725)
Work-Study	919,121	69,400			(988,521)		(988,521)
Outreach and other activities		830,751			(830,751)		(830,751)
<b>Total Governmental Activities</b>	<b>148,793,614</b>	<b>3,729,807</b>		<b>146,468,072</b>	<b>(6,055,349)</b>		<b>(6,055,349)</b>
<b>Business-Type Activities</b>							
Loan guarantee operations	5,352,889		\$ 8,677,318			\$ 3,324,429	3,324,429
Default collections	5,392,256		10,304,185			4,911,929	4,911,929
Lender assistance	3,274,270		914,926			(2,359,344)	(2,359,344)
Lender operations	62,220,539		81,977,715			19,757,176	19,757,176
Other activities	120,738		120,738				
<b>Total Business-Type Activities</b>	<b>76,360,692</b>		<b>101,994,882</b>			<b>25,634,190</b>	<b>25,634,190</b>
<b>Total Primary Government</b>	<b>\$ 225,154,306</b>	<b>\$ 3,729,807</b>	<b>\$ 101,994,882</b>	<b>\$ 146,468,072</b>	<b>(6,055,349)</b>	<b>25,634,190</b>	<b>19,578,841</b>
<b>Transfers:</b>							
Interfund transfer					2,964,707	(2,964,707)	
Transfer to KAPT						(119,136)	(119,136)
Transfer from KHESLC					3,000,000	(3,000,000)	
<b>Total General Revenue and Transfers</b>					<b>5,964,707</b>	<b>(6,083,843)</b>	<b>(119,136)</b>
<b>Change in Net Assets</b>					<b>(90,642)</b>	<b>19,550,347</b>	<b>19,459,705</b>
<b>Net Assets, Beginning of Year</b>					<b>13,930,558</b>	<b>107,476,151</b>	<b>121,406,709</b>
<b>Net Assets, End of Year</b>					<b>\$ 13,839,916</b>	<b>\$ 127,026,498</b>	<b>\$ 140,866,414</b>

See Notes to Financial Statements

## Statement of Net Assets - Proprietary Funds

## Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total
<b>ASSETS</b>							
<b>Current:</b>							
Cash and cash equivalents	\$ 4,489,791	\$ 4,628,750	\$ 9,118,541	\$ 67,999,625	\$ 5,639,133	\$ 73,638,758	\$ 82,757,299
Investments		484,437	484,437		7,673,025	7,673,025	8,157,462
Internal receivable (payable)	(2,100,551)	2,285,927	185,376	(868,610)	715,423	(153,187)	32,189
Receivable from Federal Student Loan Reserve Fund		532,728	532,728				532,728
Receivable from Agency Fund		419,339	419,339				419,339
Accounts receivable		1,179,191	1,179,191	7,021	1,378,023	1,385,044	2,564,235
Special allowance receivable				13,655,293		13,655,293	13,655,293
Accrued interest income		55,951	55,951	16,670,071	3,418	16,673,489	16,729,440
Default aversion fees receivable		368,627	368,627				368,627
<b>Total Current Assets</b>	<b>2,389,240</b>	<b>9,954,950</b>	<b>12,344,190</b>	<b>97,463,400</b>	<b>15,409,022</b>	<b>112,872,422</b>	<b>125,216,612</b>
<b>Noncurrent:</b>							
Restricted cash and cash equivalents	75,871		75,871	60,093,237		60,093,237	60,169,108
Investments		12,980,997	12,980,997				12,980,997
Internal receivable (payable) for capital projects	(75,871)	75,871					
Property and equipment, net		12,638,133	12,638,133		2,329,161	2,329,161	14,967,294
Loans, net				978,578,931		978,578,931	978,578,931
Deferred bond issuance costs, net		263,498	263,498	4,616,813		4,616,813	4,880,311
Deferred loan purchase premiums and originations costs, net				14,295,902		14,295,902	14,295,902
<b>Total Noncurrent Assets</b>		<b>25,958,499</b>	<b>25,958,499</b>	<b>1,057,584,883</b>	<b>2,329,161</b>	<b>1,059,914,044</b>	<b>1,085,872,543</b>
<b>Total Assets</b>	<b>2,389,240</b>	<b>35,913,449</b>	<b>38,302,689</b>	<b>1,155,048,283</b>	<b>17,738,183</b>	<b>1,172,786,466</b>	<b>1,211,089,155</b>
<b>LIABILITIES</b>							
<b>Current:</b>							
Accounts payable and accrued expenses	2,389,240	1,082,392	3,471,632	1,719,792	3,454,129	5,173,921	8,645,553
Accrued interest expense		64,992	64,992	1,324,273		1,324,273	1,389,265
Bonds/note payable (current portion)		350,000	350,000	98,200,000		98,200,000	98,550,000
<b>Total Current Liabilities</b>	<b>2,389,240</b>	<b>1,497,384</b>	<b>3,886,624</b>	<b>101,244,065</b>	<b>3,454,129</b>	<b>104,698,194</b>	<b>108,584,818</b>
<b>Noncurrent:</b>							
Allowance for arbitrage liabilities				20,492,839		20,492,839	20,492,839
Bonds/note payable		7,735,000	7,735,000	947,250,000		947,250,000	954,985,000
<b>Total Noncurrent Liabilities</b>		<b>7,735,000</b>	<b>7,735,000</b>	<b>967,742,839</b>		<b>967,742,839</b>	<b>975,477,839</b>
<b>Total Liabilities</b>	<b>2,389,240</b>	<b>9,232,384</b>	<b>11,621,624</b>	<b>1,068,986,904</b>	<b>3,454,129</b>	<b>1,072,441,033</b>	<b>1,084,062,657</b>
<b>NET ASSETS</b>							
Invested in capital assets, net of expended debt proceeds		4,892,502	4,892,502		2,329,161	2,329,161	7,221,663
Unrestricted					11,954,893	11,954,893	11,954,893
Restricted under bond resolutions				86,061,379		86,061,379	86,061,379
Restricted for student aid and related activities		21,788,563	21,788,563				21,788,563
<b>Total Net Assets</b>	<b>\$ -</b>	<b>\$ 26,681,065</b>	<b>\$ 26,681,065</b>	<b>\$ 86,061,379</b>	<b>\$ 14,284,054</b>	<b>\$ 100,345,433</b>	<b>\$ 127,026,498</b>

See Notes to Financial Statements

Statement of Revenues, Expenditures and Changes  
in Net Assets - Proprietary Funds

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Funds	Operating Fund	Corporation Total	Total Funds
<b>Operating Revenues:</b>							
Service fees		\$ 914,926	\$ 914,926		\$ 6,854,820	\$ 6,854,820	\$ 7,769,746
Debt recovery commission		10,284,196	10,284,196		142,845	142,845	10,427,041
Federal fees earned		7,086,395	7,086,395				7,086,395
Default aversion fee income		1,450,689	1,450,689				1,450,689
Interest and investment income		128,498	128,498	\$ 1,694,133	112,006	1,806,139	1,934,637
Interest on loans				61,097,856	52,853	61,150,709	61,150,709
Late payment penalties				304,174	984	305,158	305,158
EFF service / administration fees					11,718,044	11,718,044	11,718,044
Other income	\$ 120,738	31,725	152,463				152,463
<b>Total Operating Revenues</b>	<b>120,738</b>	<b>19,896,429</b>	<b>20,017,167</b>	<b>63,096,163</b>	<b>18,881,552</b>	<b>81,977,715</b>	<b>101,994,882</b>
<b>Operating Expenses:</b>							
Personnel and professional services	94,093	7,115,908	7,210,001		10,482,674	10,482,674	17,692,675
Other administrative expenses	16,831	3,246,641	3,263,472	21,390,605	5,679,926	27,070,531	30,334,003
Depreciation and amortization	6,746	698,753	705,499		1,533,517	1,533,517	2,239,016
Default loan collection expense		1,551,491	1,551,491				1,551,491
Default aversion expense		814,580	814,580				814,580
Amortization of bond issuance costs		33,325	33,325	292,007		292,007	325,332
Variable bond credit facility and remarketing fees				2,657,558		2,657,558	2,657,558
Reduction in arbitrage liabilities				(672,944)		(672,944)	(672,944)
Amortization of loan purchase premiums and origination costs				3,316,410		3,316,410	3,316,410
Federal consolidation fees				2,417,030		2,417,030	2,417,030
Provision for student loan loss				271,625	501,558	773,183	773,183
Interest expense	3,068	317,714	320,782	13,957,461		13,957,461	14,278,243
Other expenses		241,003	241,003	393,112		393,112	634,115
<b>Total Operating Expenses</b>	<b>120,738</b>	<b>14,019,415</b>	<b>14,140,153</b>	<b>44,022,864</b>	<b>18,197,675</b>	<b>62,220,539</b>	<b>76,360,692</b>
<b>Operating Income</b>		<b>5,877,014</b>	<b>5,877,014</b>	<b>19,073,299</b>	<b>683,877</b>	<b>19,757,176</b>	<b>25,634,190</b>
<b>Transfers In (Out):</b>							
Interfund transfer		(2,964,707)	(2,964,707)				(2,964,707)
Transfer to KAPT		(119,136)	(119,136)				(119,136)
Transfer to Governmental Fund				(3,000,000)		(3,000,000)	(3,000,000)
<b>Increase (Decrease) in Net Assets</b>		<b>2,793,171</b>	<b>2,793,171</b>	<b>16,073,299</b>	<b>683,877</b>	<b>16,757,176</b>	<b>19,550,347</b>
<b>Net Assets, Beginning of Year</b>		<b>23,887,894</b>	<b>23,887,894</b>	<b>69,988,080</b>	<b>13,600,177</b>	<b>83,588,257</b>	<b>107,476,151</b>
<b>Net Assets, End of Year</b>	<b>\$ -</b>	<b>\$ 26,681,065</b>	<b>\$ 26,681,065</b>	<b>\$ 86,061,379</b>	<b>\$ 14,284,054</b>	<b>\$ 100,345,433</b>	<b>\$ 127,026,498</b>

See Notes to Financial Statements



## Statement of Cash Flows - Proprietary Funds

## Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

	Authority			Corporation			Combined
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Fund	Operating Fund	Corporation Total	Total Funds
<b>Cash Flows From Operating Activities:</b>							
Service fees	\$ 120,738	\$ 902,189	\$ 1,022,927		\$ 7,117,248	\$ 7,117,248	\$ 8,140,173
Debt recovery commission		10,284,196	10,284,196		183,273	183,273	10,467,469
Federal fees		7,086,395	7,086,395				7,086,395
Default aversion fees		576,158	576,158				576,158
Other, net	497,965	(10,689,867)	(10,191,902)	\$ (14,985,643)	(4,809,077)	(19,794,720)	(29,986,622)
Default commission paid		(1,551,491)	(1,551,491)				(1,551,491)
Principal received on loans				175,774,555	(38,394)	175,736,161	175,736,161
Interest on loans				24,291,157	53,839	24,344,996	24,344,996
Special allowance				15,899,746		15,899,746	15,899,746
Client loan receipts					747,389,696	747,389,696	747,389,696
Loans purchased, including premiums				(21,612,995)	(618,553)	(22,231,548)	(22,231,548)
Loans originated, including costs				(335,203,777)		(335,203,777)	(335,203,777)
Credit facility fees				(2,632,205)		(2,632,205)	(2,632,205)
Loan receipts remitted to clients					(747,103,180)	(747,103,180)	(747,103,180)
<b>Net Cash Provided By (Used In) Operating Activities</b>	<b>618,703</b>	<b>6,607,580</b>	<b>7,226,283</b>	<b>(158,469,162)</b>	<b>2,174,850</b>	<b>(156,294,312)</b>	<b>(149,068,029)</b>
<b>Cash Flows From Noncapital Financing Activities:</b>							
Interfund transfers, net		134,442	134,442				134,442
Increase in Federal Student Loan Reserve receivable		(86,581)	(86,581)				(86,581)
Decrease in Agency Fund receivable		(419,339)	(419,339)				(419,339)
Cash requirements		(2,964,707)	(2,964,707)				(2,964,707)
Proceeds from debt issued				91,280,000		91,280,000	91,280,000
Debt issuance costs				(170,540)		(170,540)	(170,540)
Debt principal payments				(68,880,000)		(68,880,000)	(68,880,000)
Interest on debt				(13,935,294)		(13,935,294)	(13,935,294)
Transfer to the Governmental Fund				(3,000,000)		(3,000,000)	(3,000,000)
<b>Net Cash Provided By (Used In) Noncapital Financing Activities</b>		<b>(3,336,185)</b>	<b>(3,336,185)</b>	<b>5,294,166</b>		<b>5,294,166</b>	<b>1,957,981</b>
<b>Cash Flows From Capital and Related Financing Activities:</b>							
Interfund transfers, net	(507,931)	507,931	0				0
Proceeds from bond issuance		2,545,000	2,545,000				2,545,000
Debt issuance costs		(155,000)	(155,000)				(155,000)
Capital expenditures		(1,130,079)	(1,130,079)		(1,633,841)	(1,633,841)	(2,763,920)
Bond principal payments		(2,700,000)	(2,700,000)				(2,700,000)
Interest paid on bonds		(325,075)	(325,075)				(325,075)
<b>Net Cash Used In Capital and Related Financing Activities</b>	<b>(507,931)</b>	<b>(1,257,223)</b>	<b>(1,765,154)</b>		<b>(1,633,841)</b>	<b>(1,633,841)</b>	<b>(3,398,995)</b>
<b>Cash Flows From Investing Activities:</b>							
Purchases of investments		(31,761,725)	(31,761,725)		(13,890,123)	(13,890,123)	(45,651,848)
Proceeds from sales/maturities of investments		27,178,909	27,178,909		12,600,000	12,600,000	39,778,909
Investment income		813,058	813,058	1,827,354	115,600	1,942,954	2,756,012
<b>Net Cash Provided By (Used In) Investing Activities</b>		<b>(3,769,758)</b>	<b>(3,769,758)</b>	<b>1,827,354</b>	<b>(1,174,523)</b>	<b>652,831</b>	<b>(3,116,927)</b>
<b>Net Increases (Decrease) in Cash and Cash Equivalents</b>	<b>110,772</b>	<b>(1,755,586)</b>	<b>(1,644,814)</b>	<b>(151,347,642)</b>	<b>(633,514)</b>	<b>(151,981,156)</b>	<b>(153,625,970)</b>
<b>Cash and Cash Equivalents at Beginning of Year</b>	<b>4,454,890</b>	<b>6,384,336</b>	<b>10,839,226</b>	<b>279,440,504</b>	<b>6,272,647</b>	<b>285,713,151</b>	<b>296,552,377</b>
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 4,565,662</b>	<b>\$ 4,628,750</b>	<b>\$ 9,194,412</b>	<b>\$ 128,092,862</b>	<b>\$ 5,639,133</b>	<b>\$ 133,731,995</b>	<b>\$ 142,926,407</b>

Continued



## Statement of Cash Flows - Proprietary Funds--Continued

## Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

	Authority			Corporation		Combined	
	Internal Service Fund	Agency Operating Fund	Authority Total	Education Finance Fund	Operating Fund	Corporation Total	Total Funds
Reconciliation of revenues over expenses to net cash provided by (used in) operating activities							
Operating income		\$ 5,877,014	\$ 5,877,014	\$ 19,073,299	\$ 683,877	\$ 19,757,176	\$ 25,634,190
Adjustments to reconcile operating income to net cash provided by (used in) operating activities:							
Investment income		(128,498)	(128,498)	(1,827,354)	(115,600)	(1,942,954)	(2,071,452)
Depreciation and amortization		731,954	731,954		1,533,517	1,533,517	2,265,471
Loss on equipment disposal		124	124		15,870	15,870	15,994
Interest expense		317,714	317,714				317,714
Amortization of bond issuance costs				292,007		292,007	292,007
Amortization of loan purchase premiums and origination costs				3,316,410		3,316,410	3,316,410
Interest on debt				13,957,461		13,957,461	13,957,461
Provision for loan losses				271,625	501,558	773,183	773,183
Borrower interest converted to principal				(11,648,458)		(11,648,458)	(11,648,458)
Principal forgiveness				9,672,561		9,672,561	9,672,561
Interest forgiveness				2,512,721		2,512,721	2,512,721
Net change in fair value of investments					2,274	2,274	2,274
(Increases) decreases in assets:							
Receivables	\$ 8,501	(12,737)	(4,236)	477,824	(398,729)	79,095	74,859
Default aversion fee receivable		(59,951)	(59,951)				(59,951)
Other current assets		(379,493)	(379,493)				(379,493)
Accrued interest				557,020	1,323	558,343	558,343
Special allowance receivable				(12,499,187)		(12,499,187)	(12,499,187)
Interfund receivable/payable				(468,896)	468,896		-
Increases (decreases) in liabilities:							
Accounts payable and accrued expenses	15,118	12,943	28,061	(441,035)	138,811	(302,224)	(274,163)
Interfund payable	595,084	248,510	843,594				843,594
Allowance for arbitrage liabilities				(672,943)		(672,943)	(672,943)
Items not accounted for as revenues or expenses:							
Principal received on loans				175,774,555	(38,394)	175,736,161	175,736,161
Loans purchased, including premiums				(21,612,995)	(618,553)	(22,231,548)	(22,231,548)
Loans originated, including costs				(335,203,777)		(335,203,777)	(335,203,777)
<b>Net Cash Provided By (Used In) Operating Activities</b>	<b>\$ 618,703</b>	<b>\$ 6,607,590</b>	<b>\$ 7,226,293</b>	<b>\$ (158,469,162)</b>	<b>\$ 2,174,850</b>	<b>\$ (156,294,312)</b>	<b>\$ (149,068,029)</b>

See Notes to Financial Statements

Balance Sheet-Governmental Fund

Kentucky Higher Education Assistance Authority

June 30, 2004

	<b>Governmental Fund Student Aid</b>
<b>ASSETS</b>	
<b>Current:</b>	
Cash and cash equivalents	\$ 1,620,523
Accounts receivable	2,058,556
Teacher and Osteopathic Medicine Scholarship loans (current portion)	450,000
Other current assets	8,744
<b>Total Current Assets</b>	<b>4,137,823</b>
<b>Noncurrent:</b>	
Teacher and Osteopathic Medicine Scholarship loans, net of allowance of \$3,900,000	3,111,749
Teacher and Osteopathic Medicine Scholarship advances	6,860,053
<b>Total Noncurrent Assets</b>	<b>9,971,802</b>
<b>Total Assets</b>	<b>\$ 14,109,625</b>
<b>LIABILITIES</b>	
<b>Current:</b>	
Interfund payable	\$ 32,189
Accounts payable	237,520
<b>Total Liabilities</b>	<b>269,709</b>
<b>NET ASSETS</b>	
Fund Balance - restricted for program benefits	13,839,916
<b>Total Liabilities and Fund Balance</b>	<b>\$ 14,109,625</b>

See Notes to Financial Statements

Statement of Revenues, Expenditures and Changes  
in Fund Balance - Governmental Fund

**Kentucky Higher Education Assistance Authority**

*For the Year Ended June 30, 2004*

	<b>Governmental Fund Student Aid</b>
<b>Revenues:</b>	
Interest and investment income fund	\$ 222,810
Tobacco Settlement revenue	750,000
State General Fund revenue	70,843,693
Student Aid and Advancement Fund revenue	72,745,982
Federal funds revenue	1,157,936
Other income	747,651
<b>Total Revenues</b>	<b>146,468,072</b>
<b>Expenditures:</b>	
Kentucky Tuition Grant	23,640,343
College Access Program Grant	46,098,392
Early Childhood Development Scholarship	833,131
National Guard Tuition Award	2,621,895
Kentucky Educational Excellence Scholarship	73,251,730
Teacher Scholarship	734,410
Osteopathic Medicine Scholarship	3,524,248
Work-Study	988,521
Outreach and other activities	830,751
<b>Total Expenditures</b>	<b>152,523,421</b>
<b>Excess of Expenses Over Revenues</b>	<b>(6,055,349)</b>
<b>Other Financing Sources and Uses, Including Transfers</b>	
Interfund transfers	2,964,707
Transfer from KHESLC	3,000,000
<b>Net Change in Fund Balance</b>	<b>(90,642)</b>
<b>Fund Balance, Beginning of Year, As Restated</b>	<b>13,930,558</b>
<b>Fund Balance, End of Year</b>	<b>\$ 13,839,916</b>

See Notes to Financial Statements



## Statement of Fiduciary Net Assets (Deficit)

## Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

ASSETS	Federal Student Loan Reserve Fund	Agency Fund	Kentucky's Affordable Prepaid Tuition	Kentucky's Education Savings Plan Trust
<b>Current:</b>				
Cash and cash equivalents	\$ 8,137,613	\$ 170,573	\$ 8,634,271	\$ 475,909
Contributions receivable			5,715,443	
Fees receivable			175,778	
Investments	100,000			51,974,588
Receivables	8,026,442	419,339		22,485
Accrued interest income	88,541		235,979	
Other current assets	186,720			
<b>Total Current Assets</b>	<b>16,539,316</b>	<b>589,912</b>	<b>14,761,471</b>	<b>52,472,982</b>
<b>Noncurrent:</b>				
Investments	2,535,737		54,928,393	
Contributions receivable			18,685,352	
Restricted investments, cash and cash equivalents	2,302,290			
Furniture and equipment, at cost, less accumulated depreciation			4,534	
<b>Total Noncurrent Assets</b>	<b>4,838,027</b>		<b>73,618,279</b>	
<b>Total Assets</b>	<b>21,377,343</b>	<b>589,912</b>	<b>88,379,750</b>	<b>52,472,982</b>
<b>LIABILITIES</b>				
<b>Current:</b>				
Accounts payable	3,105,493		45,367	46,924
Accrued expenses	2,300,000			26,650
Origination distribution payable		170,573		
Payable to Agency Operating Fund	532,728	419,339		
Payable to transfer agent				3,033
Notes payable (current portion)			900,000	
Default aversion fees payable	368,627			
<b>Total Current Liabilities</b>	<b>6,306,848</b>	<b>589,912</b>	<b>945,367</b>	<b>76,607</b>
<b>Noncurrent:</b>				
Tuition benefits payable			99,323,706	
<b>Total Noncurrent Liabilities</b>			<b>99,323,706</b>	
<b>Total Liabilities</b>	<b>6,306,848</b>	<b>589,912</b>	<b>100,269,073</b>	<b>76,607</b>
<b>NET ASSETS (DEFICIT)</b>				
Restricted for program benefits			(11,889,323)	52,396,375
Restricted for USDE recall	2,302,290			
Restricted for other purposes	12,768,205			
<b>Total Net Assets (Deficit)</b>	<b>\$ 15,070,495</b>		<b>\$ (11,889,323)</b>	<b>\$ 52,396,375</b>

See Notes to Financial Statements

Statement of Changes in Fiduciary Net Assets (Deficit)

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2004

	<b>Federal Student Loan Reserve Fund</b>	<b>Kentucky's Affordable Prepaid Tuition</b>	<b>Kentucky's Education Savings Plan Trust</b>
<b>Additions:</b>			
Federal reinsurance	\$ 43,821,099		
Fee revenue		\$ 102,719	
Contract income, net		2,256,417	
Subscriptions			\$ 12,700,472
<b>Investment Revenue:</b>			
Net unrealized gain on investments		4,224,684	3,591,598
Interest and investment income	66,343	3,628,057	1,752,598
Other income	343,604	17,034	
<b>Total Additions</b>	<b>44,231,046</b>	<b>10,228,911</b>	<b>18,044,668</b>
<b>Deductions:</b>			
Program benefits:			
Loan claims	45,715,095		
Default aversion fee expense	1,450,689		
Redemptions			1,895,710
Redemption expenses			3,727
Administrative expenses		167,051	291,712
Personnel and professional expenses		561,844	
Refunds		354,616	
Trustee fee expense		139,901	
Tuition benefits expense		11,399,497	
Other expenses	779,889	1,094	
<b>Total Deductions</b>	<b>47,945,673</b>	<b>12,624,003</b>	<b>2,191,149</b>
<b>Change in Net Assets Before Transfer</b>	<b>(3,714,627)</b>	<b>(2,395,092)</b>	<b>15,853,519</b>
<b>Transfer from Internal Service Fund</b>		<b>119,136</b>	
<b>Change in Net Assets After Operating Transfer</b>	<b>(3,714,627)</b>	<b>(2,275,956)</b>	<b>15,853,519</b>
<b>Net Assets (Deficit) at Beginning of Year</b>	<b>18,785,122</b>	<b>(9,613,367)</b>	<b>36,542,856</b>
<b>Net Assets (Deficit) at End of Year</b>	<b>\$ 15,070,495</b>	<b>\$ (11,889,323)</b>	<b>\$ 52,396,375</b>

See Notes to Financial Statements



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**1. Description of Business**

The Kentucky Higher Education Assistance Authority (the Authority) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. To that end, the Authority guarantees Federal Family Education Loan Program (FFELP) loans; makes student loans directly to parents and students, purchases and services eligible student loans, and performs servicing and collection activities on eligible student loans for third-party lenders through the Kentucky Higher Education Student Loan Corporation (the Corporation); offers investment opportunities to help Kentuckians save for future higher education expenses through the Kentucky Education Savings Plan Trust (the Trust); and offers Kentuckians an opportunity to pay future tuition and related expenses at reduced present-value rates through Kentucky's Affordable Prepaid Tuition Plan (the Plan).

The Authority guarantees loans to qualified students and parents of qualified students made by approved lenders in Kentucky and Alabama. Commencing in 1969, retroactive to 1965, the federal government agreed to insure 80% of such guarantee student loans under the Guaranteed Student Loan Program (now known as the Federal Family Education Loan Program [FFELP]). FFELP, under which the Authority operates, was established by Congress and is administered by the U.S. Department of Education (USDE) as a means of making loans available to students attending colleges, universities, and vocational institutions. FFELP provides for the Authority to guarantee the repayment of principal and accrued interest to lenders for each eligible student loan. The Authority is responsible for processing loans submitted for guarantee, issuing loan guarantees, providing collection assistance to lenders for delinquent loans, paying lender claims for loans in default, and collecting loans on which default claims have been paid. The Authority also educates schools and lenders about FFELP requirements and regulatory changes, and encourages lender participation. Effective January 10, 1977, the Authority entered into a supplemental guaranty agreement with the federal government which provided up to 100% reimbursement, depending upon default experience as specified in the agreement. Subsequently, federal reinsurance on guaranteed loans made from October 1, 1992, to September 30, 1998, was reduced to a maximum of 98%; and federal reinsurance on guaranteed loans made on or after October 1, 1998, was reduced to a maximum of 95% (see Note 5).

The Higher Education Amendments of 1998 (the "1998 Amendments") that were enacted on October 7, 1998, with an effective date of October 1, 1998, changed the manner in which FFELP is administered. Under the 1998 Amendments, the Authority established a Federal Student Loan Reserve Fund (FSLRF) and an Agency Operating Fund (AOF) as required to account for FFELP activities. The FSLRF assets and all earnings on those assets (except investment income on the 1997 Balanced Budget Act set-aside funds) are the property of the federal government. The reserves of the Authority were required to be deposited in the new FSLRF no later than 60 days after enactment. The result of this federal legislation was that the Authority's fund equity of approximately \$40.6 million was transferred to the newly established FSLRF, and the Authority's AOF commenced activities with a zero-fund equity. The funds in the newly established FSLRF were used to pay for reimbursements to lenders for defaulted student loan claims and pay the AOF for default aversion fees. Funds used to pay loan claims are replenished from reimbursements from the federal government.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**1. Description of Business--Continued**

Other sources of revenues to the FSLRF include the federal compliment on collections of defaulted loans and investment income. All of the other sources and uses of funds not related to the FSLRF are recorded in the AOF. The AOF assets and earnings on those assets are the property of the Authority and may be used generally for all guaranty agency and other student financial aid related activities.

Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees, account maintenance fees (.10% of Original Principal Balance Outstanding as of September 30), and loan processing and insurance fees (.40% of loans guaranteed and disbursed during the federal fiscal year).

Expenditures from the AOF include personnel, professional and other administrative expenses directly related to loan program operations, and commission expense paid to external collection agencies. Both the FSLRF and AOF are subject to federal oversight.

The Corporation is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for postsecondary students in the Commonwealth of Kentucky. Governed by a Board of Directors, the Corporation is authorized to finance loans for students attending eligible postsecondary institutions, service and collect education loans, and issue bonds and notes not to exceed \$1.95 billion in order to carry out its corporate powers and duties. The Corporation's education finance, servicing, and collection activities include: (1) origination and secondary market acquisition of education loans originated pursuant to the FFELP; (2) the financing of FFELP loans; (3) the servicing of FFELP and other education loans, and (4) the collection of FFELP and other education loans for other holders on a commission or cost reimbursement basis. FFELP student loans held, serviced, and collected by the Corporation include Federal Subsidized Stafford Loans (Stafford), Federal Unsubsidized Stafford Loans (Unsubsidized Stafford), Federal Supplemental Loans for Students (SLS), Federal Parent Loans for Undergraduate Students (PLUS), and Federal Consolidation Loans (Consolidation).

FFELP loans held by the Corporation are insured by the Authority, as the state guarantee agency, or the USDE. Loans made prior to October 1, 1993, are 100% insured. Loans made on or after October 1, 1993, are 100% insured against borrowers' death, disability, or bankruptcy and 98% insured against borrowers' default.

The Corporation's General Bond Resolutions (GBRs) and separate Series Resolutions for issuance of revenue bonds contain provisions establishing funds and accounts for the segregation of assets and provisions restricting the use of the proceeds of bonds and other funds received.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**1. Description of Business--Continued**

As of June 30, 2004, the Corporation serviced approximately \$979 million outstanding principal amount of FFELP Loans, which are pledged pursuant to the 1983 GBR, the 1997 GBR, or the 2000 Line of Credit Trust Agreement and approximately \$4.6 billion of FFELP loans and other education loans on behalf of other holders, including holders with national lending operations. The majority of such education loans are being serviced by the Corporation pursuant to servicing agreements which do not provide for the acquisition by the Corporation of the education loans serviced. As a servicer of FFELP loans, the Corporation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities. In addition, the Corporation currently collects approximately \$158 million of FFELP loans and other education loans for other holders on a commission or cost reimbursement basis. The Corporation's obligations pursuant to such servicing and collection agreements are without recourse to assets pledged to collateralize any Corporation financings.

In addition to operations related to FFELP, the Authority administers the Kentucky Education Savings Plan Trust (Trust) and eight state grant and scholarship programs.

The Trust was formed on July 15, 1988 to help families save for the costs of education after high school. The Trust is administered by the Board of Directors. The Authority has contracted with TIAA-CREF Tuition Financing, Inc. (TFI), a wholly-owned subsidiary of Teachers Insurance and Annuity Association of America (TIAA), for management services over the Trust's operations. The Trust is operated in a manner such that it is exempt from registration as an investment company under the Investment Company Act of 1940.

An individual participating in the Trust establishes an account in the name of a beneficiary. Contributions can be made among three investment options: the Managed Allocation Option, the 100% Equity Option and the Guaranteed Option.

Contributions to the Managed Allocation Option are allocated among six age bands, based on the age of the beneficiary. Prior to January 17, 2004, there were eleven age bands. Each age band invests in varying percentages in the Institutional Class of the International Equity, Growth Equity, Growth & Income, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities and Money Market Funds of the TIAA-CREF Institutional Mutual Funds. The 100% Equity Option invests in varying percentages in the Institutional Class of the International Equity and Growth & Income Funds of the TIAA-CREF Institutional Mutual Funds. All allocation percentages are determined by the Board and are subject to change. The assets of the Guaranteed Option are allocated to a funding agreement issued by TIAA-CREF Life Insurance Company, a subsidiary of TIAA, which offers a guarantee of principal and a minimum rate of return to the Trust.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**1. Description of Business--Continued**

The Authority also administers the Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition, or KAPT, (the "Plan"), which was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes (KRS) 164A.700-709.

Effective July 1, 2003, responsibility for governance and administration of the Plan was transferred to the Authority. In connection with the transfer of responsibility, the Plan became a fiduciary fund of the Authority.

The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

The Plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition units at current tuition levels and receive benefits equal to tuition rates in place at the time that the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan, and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky.

Participants may elect to spread payments to the Plan over three, five, or seven years or until the anticipated year of the student's enrollment in a qualified postsecondary education institution.

Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college, or university in the United States. If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books, and supplies.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**1. Description of Business--Continued**

Participants may withdraw from the Plan at any time for any reason. Terminating participants are refunded any contract payments made less benefits received and administrative and cancellation fees. Non-qualified withdrawals are subject to a 10% penalty in accordance with Section 529 of the Internal Revenue Code (IRC) except in cases where the withdrawal is: (1) made on account of the death or disability of the student, (2) made on account of a scholarship received by a student, or (3) a non-taxable transfer to another account or to another IRC Section 529 program for a different student who is a family member of the original student.

The Authority administers the Trust, the Plan, Kentucky Educational Excellence Scholarship, College Access Program grant, Kentucky Tuition Grant, Teacher Scholarship, Osteopathic Medicine Scholarship, and Work-Study and manages funds for the Kentucky National Guard Tuition Award Program. The 2000 General Assembly enacted legislation giving the Authority administrative responsibility for a certain portion of the Early Childhood Development Scholarship Program. The Authority's grant, scholarship, and work-study programs are funded by appropriations from the Kentucky General Assembly, grants from the USDE, and allocation of revenues from the Kentucky Lottery Corporation, Coal Severance Tax, Tobacco Settlement funds, and transfers from the AOF.

The Corporation, the Plan, and the Trust each published separate financial statements and footnotes. To obtain a copy of the financial statements and footnotes, please contact the Authority at (502) 696-7421.

**2. Summary of Significant Accounting Policies**

**a. Basis of Presentation**

The Authority reports its financial information in accordance with the Government Accounting Standard Board (GASB) Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis - for State and Local Governments" as amended by GASB No. 37 and modified by GASB No. 38, "Certain Financial Statement Disclosures," (collectively GASB 34).

The Authority's basic financial statements are prepared in accordance with GASB 34 and are comprised of three components: (1) government-wide financial statements; (2) fund financial statements, and (3) notes to the financial statements.

The government-wide financial statements are comprised of a statement of net assets and a statement of activities. Prepared using the economic resources measurement focus and the accrual basis of accounting, these statements reflect all of the assets, liabilities, revenues, expenses, gains and losses of the combined Authority's governmental and business-type activities. The Authority's governmental activities reflect the activities of administering the various student grant, scholarship, loan, work-study programs for the Commonwealth of Kentucky and the USDE. The Authority's business-type activities include the activities of administering loan guarantee, default collection, lending and related activities, and other lender services.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

The government-wide financial statements do not reflect fiduciary activities whose resources are not available to finance the Authority's programs. Fiduciary activities include private-purpose trust and agency funds administered by the Authority pursuant to FFELP and the Trust.

The Authority's combined fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States applicable to state government entities, which provides that accounting systems be organized by funds to account for specific activities consistent with legal and operating requirements. The Authority's governmental funds include the activities of administering grant, scholarship, loan, and work-study programs for the Commonwealth of Kentucky and the USDE. Financial activities operated similarly to users of the Authority's loan guarantee, default collection, and other lender services are presented as proprietary funds. Propriety funds also include internal service funds, which are used to report activity that provides goods or services on a cost reimbursement basis predominantly to the Authority's other business-type activities. The Authority follows all applicable Accounting Principles Board Opinions, issued on or before November 30, 1989, for its proprietary funds, unless those pronouncements conflict with or contradict GASB pronouncements.

The Authority's fiduciary funds include the FSLRF, which is used to account for assets, liabilities, revenues, and expenses the Authority administers for the federal government as noted above.

The Authority's fiduciary funds include agency funds, which are held in a purely custodial capacity. The Agency Fund includes proceeds received from student loan lenders and later remitted to a college or university to pay for tuition assistance for a respective student. The fiduciary funds also includes assets, liabilities, additions, and deductions to net assets related to the Trust and the Plan. Assets of the Trust are held by the Authority on behalf of program participants. Assets of the Plan are held by the Authority to offset future tuition obligations of participants.

The Authority uses the accrual basis of accounting.

**b. Investments**

Investments for all funds except the Plan consist primarily of securities of the federal government or its agencies; commercial paper and collateralized mortgage obligations and mutual funds; and are stated at fair market value. Fair market value is determined by using quoted market prices as of the last day of the fiscal year.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

The Plan invests in certain debt and equity instruments, which are reported at fair value. Fair values are determined using quoted market values as of the last day of the reporting period where available. Securities for which quoted market prices are not available are valued using estimates based on similar securities.

To achieve an actuarially determined target rate of gross return of 7.76% before fees and expenses, investments shall be held in approximately the following composition.

Large cap U. S. stocks	45%
Small/Miscap U. S. stocks	10%
Non-U. S. stocks	3%
Private equity (not to exceed)	<u>2%</u>
<b>Total Equity</b>	<u><b>60%</b></u>
 Inflation indexed bonds	 25%
Corporate bonds	<u>15%</u>
<b>Total Fixed Income</b>	<u><b>40%</b></u>

To decrease overall investment risk, the following restrictions apply to the Plan's investments:

- i. No more than 5% of the total amount of the equity portion of the investment account in the securities of any one issuer;
- ii. No more than 25% of the total amount of the equity portion of the investment account in any one industry, as defined by Standard & Poors;
- iii. For portfolios invested in major-market countries, no more than 25% of the total amount of the equity portion of the investment account in any one country with the exception of those countries whose weighting in the Europe, Australia, and Far East index benchmark plus 10% is permitted;
- iv. For portfolios invested in emerging markets, no more than 20% of the equity portion of the investment account shall be invested in one country;
- v. A minimum of eight countries shall be represented in each investment account; and
- vi. No more than 10% of the total amount of the fixed-income portion of the investment account shall be committed to the securities of any one issuer at the time of purchase, with the exception of securities issued or guaranteed by the full faith and credit of the United States of America or AAA-related securities issued by government agencies as to which there is no limit.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

**c. Teacher and Osteopathic Medicine Scholarship Loans and Advances**

Teacher scholarship advances to students may be repaid via eligible service credits granted for specified teaching in primary or secondary schools. The disbursements are recorded as advances and charged to program benefits over the period the teaching service is performed. If the teaching requirements are not satisfied, the advances are converted to loans, which are repayable with interest.

Osteopathic Medicine Scholarship advances to students may be repaid via eligible service credits granted for working as a doctor in Kentucky. The expenditures are recorded as advances and charged to program benefits over the period that the medical services are provided. If the medical requirements are not satisfied, the advances are converted to loans, which are repayable with interest.

**d. Property and Equipment**

Property and equipment, including construction in progress, is stated at cost, less accumulated depreciation. Property and equipment is depreciated beginning when the assets are placed in service and continue over the estimated useful lives of the respective asset using the straight-line method. Net interest cost incurred during the construction period of significant proprietary funds assets is capitalized as part of the respective asset cost.

**e. Defaulted Student Loans**

All collections on defaulted loans are recorded as income when received. The portion of collections due to the federal government is treated as an expense. Federal defaulted loans outstanding are accounted for by the Authority but are not presented on the accompanying statement of net assets.

**f. Allowance for Uncollectible Loans**

As discussed in Note 1, the Corporation's FFELP loans are guaranteed by the Authority. Management believes that the Authority will be able to honor all default claims submitted by the Corporation. However, the Corporation records a provision for loan losses based upon its expected default claims with respect to 98% insured loans and for loans with certain loan servicing violations. The allowance for loan losses on FFELP loans was \$872,581 for loan principal and \$138,985 for accrued interest as of June 30, 2004. Furthermore, the Corporation is required to purchase loans owned by third-party customers with certain loan servicing violations. As of June 30, 2004, the allowance for third-party servicing loan losses was \$1,648,266 for loan principal and \$114,830 for accrued interest.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

**g. Interest Income on Loans**

The Corporation earns interest income on loans from three sources: (1) the USDE for subsidized interest earned while certain students are in school (2) special allowance subsidies (discussed in Footnote 7) and (3) borrowers. All interest is recorded when earned and is shown in the financial statements net of the interest-related portion of the provision for loan losses.

**h. Commission on Debt Recovery**

The Authority fee for collection of defaulted education loans is recorded as commission revenue when earned. Loans for which the Corporation performs debt recovery services are not presented on the statement of net assets, as they are not owned by the Authority.

**i. Servicing Fees**

The Authority's fees for servicing loans held by third parties are recorded as servicing fee revenue when earned. These third-party loans are not presented on the statement of net assets, as they are not owned by the Authority.

**j. Deferred Loan Purchase Premium and Deferred Loan Origination Costs**

Loan purchase premiums and certain origination costs are deferred and amortized over the estimated life of the loans acquired or originated, based on projected balances outstanding, which approximates the effective interest method.

**k. Deferred Bond Issuance Costs**

Bond issuance costs are deferred and amortized over the life of the bonds, utilizing the bonds outstanding method, which approximates the effective interest method.

**l. Income Taxes**

The Authority is a state government agency established by the Kentucky General Assembly and is, therefore, not subject to federal or state income taxes. The Corporation is an independent *de jure* municipal corporation and political subdivision of the Commonwealth of Kentucky and is therefore not subject to federal or state income taxes.

**m. Statement of Cash Flows**

In the statements of cash flows, the Authority considers cash and cash equivalents to include highly liquid investments, which mature within one month of purchase.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

**n. Use of Estimates**

The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**o. Interfund Eliminations**

Interfund receivables and payables are eliminated in the governmental and business-type activities column of the statement of net assets. Net residual amounts due between governmental and business-type activities are reflected as receivable (payable) for internal balances. Amounts reported in funds as receivable from or payables to fiduciary funds are reflected in the statement of net assets. Eliminations are made in the statement of activities to remove the doubling-up effect of internal service fund activity.

**p. Program Revenues**

Program revenues are reported in two categories, including: (1) charges for services and (2) program-specific operating grants and contributions. Charge for services include revenues received in the form of fees and charges for the Authority loan guarantee, default collection, and other lender services, and interest income from corporate lending activities. Program-specific operating grants and contributions include revenues from mandatory and voluntary nonexchange transactions with other government and organizations that are restricted for use in a particular program. Program-specific operating grant and contribution services include the interest earned on scholarship loans.

**q. Contribution Receivable**

As discussed in Note 1, participants may elect to make payments on executed tuition contracts over a specific period. Contributions receivable are recorded at their net realizable value in the period in which a tuition contract is purchased. A finance charge of 7.25% per year is charged to participants based on outstanding balances.

**r. Note Payable**

The Plan's start-up costs were funded by a \$1 million note from the Commonwealth of Kentucky Unclaimed Property Fund.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**2. Summary of Significant Accounting Policies--Continued**

**s. Tuition Benefits Payable**

Tuition benefits payable are reported at the actuarial net present value of estimated future benefits to be paid on behalf of participants. The reported amount reflects actuarial assumptions, including anticipated tuition and fee increases; expected investment earnings, and refunds and other terminations.

**t. Indirect Cost**

Indirect costs are allocated amount functions/programs utilizing a full cost allocation approach with the objective of allocating all expenses to the Authority's various functions and programs.

**u. Operating Revenues and Expenses**

The Authority follows a policy of defining proprietary funds operating and nonoperating revenues and expenses using the guidance set forth in GASB Statement No. 9.

**v. Risk Management**

The Authority is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage for these various risks of loss are obtained through the Authority's participation in the Commonwealth of Kentucky's Risk Management Fund and State Sponsored Group Insurance Fund.



Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**3. Cash and Investments**

Cash and investments as of June 30, 2004, are summarized as follows

	At Fair Market Value			
	Investments	Cash Equivalents	Cash	Total
Governmental Fund:				
Cash deposited with Kentucky State Treasurer			\$ 1,620,523	\$ 1,620,523
Proprietary Funds:				
U.S. Treasury and government agency securities	\$ 20,639,485			20,639,485
Collateralized mortgage obligations	2,195,479			2,195,479
Corporate bonds	1,439,838			1,439,838
Municipal bonds	35,161			35,161
Money market securities		\$ 87,895,363		87,895,363
Government mutual funds		42,977,692		42,977,692
	24,309,963	130,873,055		155,183,018
Cash in bank			4,316,186	4,316,186
Cash deposited with Kentucky State Treasurer			4,565,662	4,565,662
	24,309,963	130,873,055	8,881,848	164,064,866
Fiduciary Funds:				
FSLRF Trust and Agency Fund:				
U.S. Treasury and government agency securities	2,252,343			2,252,343
Collateralized mortgage obligations	2,685,684			2,685,684
TIAA Institutional Mutual Funds		51,974,588		51,974,588
Corporate stocks	36,134,185			36,134,185
Corporate bonds	18,794,208			18,794,208
Mutual funds		13,954,422		13,954,422
	59,866,420	65,929,010		125,795,430
Cash in bank			3,373,481	3,373,481
Cash deposited with Kentucky State Treasurer			90,463	90,463
	59,866,420	65,929,010	3,463,944	129,259,374
Totals	\$ 84,176,383	\$ 196,802,065	\$ 13,966,315	\$ 294,944,763

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**3. Cash and Investments--Continued**

Deposits, identified as cash in the above summary, as of June 30, 2004, are as follows:

	<b>Financial Statement Amount</b>	<b>Bank Balance</b>
Insured (FDIC)	\$ 600,000	\$ 600,000
Uninsured:		
Covered by trustee agreement	7,089,667	8,144,860
On deposit with Kentucky State Treasurer	<u>6,276,648</u>	<u>6,276,648</u>
Total	<u>\$13,966,315</u>	<u>\$15,021,508</u>

Investments, including cash equivalents, categorized as of June 30, 2004, are summarized as follows:

	<b>Category 1</b>	<b>Uncategorized</b>	<b>Total</b>
U.S. Treasury and government agency obligations	\$ 22,891,828		\$ 22,891,828
Collateralized mortgage obligations	4,881,163		4,881,163
TIAA Institutional Mutual Funds		\$ 51,974,588	51,974,588
Corporate stocks	36,134,185		36,134,185
Corporate bonds	20,234,046		20,234,046
Municipal bonds	35,161		35,161
Money market securities		87,895,363	87,895,363
Government mutual funds		<u>56,932,114</u>	<u>56,932,114</u>
Total	<u>\$ 84,176,383</u>	<u>\$ 196,802,065</u>	<u>\$ 280,978,448</u>

The Authority is limited, by federal regulations, to invest in low risk securities, which are outlined in the Authority's Investment Policy and approved by the Board of Directors. The Authority's investments at year-end are categorized to give an indication of the level of credit risk assumed by the Authority. Category 1 Investments includes investments that are insured, registered, or held by the Authority or its agent in the Authority's name.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**3. Cash and Investments--Continued**

The FSLRF and AOF cash and investments are held by a corporate trustee as part of the Loan Guarantee Fund authorized by Chapter 164,754 of the Kentucky Revised Statutes.

The Higher Education Act of 1965, as amended, states the Authority must maintain a .25% minimum reserve level requirement. Assets of the Federal Fund must be at least .25% of the agency-guaranteed loan portfolio's original principal balance outstanding.

The Authority was in compliance with its minimum reserve level requirement as of June 30, 2004 as follows:

Outstanding loans (original principal balance)	\$ 3,565,388,591
Minimum reserve requirement	8,913,471
Federal Fund cash and investments	13,075,640

The 1997 Budget Reconciliation Act required payment of a portion of Federal Fund reserves to the U.S. Treasury, approximately \$14.2 million, on September 1, 2002. Prior to sending the payment to the U.S. Treasury, the Authority placed the funds in a designated investment account. The interest from the amount reserved was accumulated in a separate account. The interest earnings on the reserved funds may be utilized for new default aversion activities as defined in federal regulations. The 1998 amendments also required an additional \$3.5 million to be sent to the U.S. Treasury in three installments. On September 1, 2002, the Authority paid the first installment to the U.S. Treasury. The second and third installments total \$2,302,290 and are due in fiscal year 2005 and 2006, respectively.

Because these cash and investment reserves are completely restricted and not available for the Authority's use in the FFELP program, it has been classified accordingly in the accompanying statement of fiduciary net assets (deficit).

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2004

4. Property and Equipment

A summary of Property and Equipment follows

	June 30, 2003	Additions	Deletions	June 30, 2004
Proprietary fund:				
Furniture and equipment	\$ 10,673,004	\$ 2,116,348	\$ (154,044)	\$ 12,635,308
Building	8,779,183	3,062,770		11,841,953
Construction in progress	2,399,199		(2,399,199)	-
System development information services	55,955			55,955
Student Loan Servicing System	541,131			541,131
Debt Recovery System	139,350			139,350
Accumulated depreciation	(7,882,730)	(2,484,891)	121,218	(10,246,403)
	<u>\$ 14,705,092</u>	<u>\$ 2,694,227</u>	<u>\$ (2,432,025)</u>	<u>\$ 14,967,294</u>
Fiduciary fund:				
Furniture and equipment	\$ 655,368	\$ 5,628	\$ (4,550)	\$ 656,446
Accumulated depreciation	(499,530)	(156,673)	4,291	(651,912)
	<u>\$ 155,838</u>	<u>\$ (151,045)</u>	<u>\$ (259)</u>	<u>\$ 4,534</u>

Depreciation expense totaled \$2,484,891 for the year ended June 30, 2004, of which \$2,239,016 was allocated to business-type activities, \$236,638 was allocated to governmental activities and \$9,237 was allocated to the fiduciary activities. Depreciation expense was allocated to the business-type activities functions as follows:

Loan guarantee operations	\$ 332,018
Default collections	182,137
Lending and related activities	1,533,517
Lender assistance	184,598
Other	6,746
	<u>\$ 2,239,016</u>



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**5. Federal Family Education Loan Programs**

Pursuant to FFELP, the Authority insures eligible student loans for losses incurred from the default, death, disability, or bankruptcy of the borrower and also insures for other losses such as school closures and false certifications. As of June 30, 2004, the outstanding balance of aggregate insured student loans was approximately \$2,908,356,000.

Loans insured by the Authority are reinsured under FFELP by the federal government. Death, disability, bankruptcy, lender of last resort, and closed school claims are reinsured at 100%. Default claims are subject to the Authority's default claims rate (reimbursed default claims for the federal fiscal year divided by the original principal amount of loans in repayment at the beginning of the fiscal year).

Reimbursement for default claims is determined according to the following schedule:

The Authority's annual default claims rate is within the 5%, which allows for reimbursement rates at the highest level. Due to the reduction of the federal reimbursement rate for loans made subsequent to October 1, 1993, the Authority has recorded an allowance of \$3.3 million at June 30, 2004, for losses on federal reinsurance.

Through September 30, 1993	October 1, 1993 through September 30, 1998	October 1, 1998 and After
100%	98%	95%
100% of claims up to 5%, plus 90% of claims over 5% up to 9%	98% of claims up to 5%, plus 88% of claims over 5% up to 9%	90% of claims to 5%, plus 85% of claims over 5% up to 9%
100% of claims up to 5%, plus 90% of claims over 5% up to 9%, plus 80% of claims over 9%	98% of claims to 5%, plus 88% of claims over 5% up to 9%, plus 78% of claims over 9%	95% of claims to 5%, plus 85% of claims over 5% up to 9%, plus 75% of claims over 9%

The Authority is entitled to charge certain fees associated with its reinsurance activities. A summary of those fees are as follows:

**Rehabilitated and Consolidated Loans:** The Authority is entitled to retain 18.5% of principal and interest for rehabilitated loans, plus 18.5% of collection costs. For consolidated loans, the Authority is entitled to the 18.5% collection costs.

**Recoveries Payable to Federal Government:** The Authority is entitled to retain 24% of collections received for defaulted loans for which federal reinsurance has been received. This amount is recorded as an addition when received. After September 30, 2003, the retention rate decreased to 23% as required by the 1998 Amendments.

Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**5. Federal Family Education Loan Programs--Continued**

**Account Maintenance Fees (AMF):** The 1998 Amendments established an account maintenance fee based on .12% of the original principal amount of outstanding loans. AMF is paid to the Authority on a quarterly basis by the federal government. This fee is recognized as revenue and recorded in the AOF. In fiscal year 2001, the AMF was reduced to .10% of the original principal amount of outstanding loans.

**Loan Processing and Issuance Fees (LPIF):** The 1998 Amendments established a loan processing and issuance fee. LPIF payments are based on the net guarantee amount, less cancellations, multiplied by .65%. LPIF is paid to the Authority on a quarterly basis by the federal government. This fee is recognized as revenue and recorded in the AOF. Effective in September 30, 2003, LPIF was reduced to .40% of net guarantees, less cancellations.

**Default Aversion Fees (DAF):** Default aversion fees were established under the 1998 Amendments. The Authority receives DAF for its aversion activities on delinquent loans at the time lenders request default aversion assistance. DAF's are equal to 1% of principal and interest on the loan at the time the Authority receives a request from a lender for preclaim assistance. DAF is paid monthly from the FSLRF to the AOF and is recognized as a deduction in the FSLRF and as revenue in the AOF.

**6. Loans**

The Corporation originates, purchases and holds various types of student loans as described in Note 1. The terms of these loans, which vary on an individual basis depending upon loan type and the date the loan was originated, generally provide for repayment in monthly installments of principal and interest over a period of up to 30 years for Consolidation loans and generally up to 10 years for other loans. The repayment period begins after a grace period of six months following graduation or loss of qualified student status for the Subsidized and Unsubsidized Stafford loans. The repayment period for Consolidation, SLS, and PLUS loans begins within 60 days from the date the loan is fully disbursed. Interest rates on student loans ranged from 2.82% to 12% for the fiscal year ended June 30, 2004, depending upon the type and date of origination of the individual loan.

Continued



Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**6. Loans--Continued**

Loans consist of the following at June 30, 2004

Stafford – Subsidized	\$ 407,154,009
Stafford – Unsubsidized	291,341,583
PLUS/SLS	22,221,486
Consolidation	258,842,655
Other	<u>1,540,045</u>
Total Gross Loans	981,099,778
Allowance for loan loss	<u>(2,520,847)</u>
Net Loans	978,578,931
Net deferred premium and loan costs	<u>14,295,902</u>
Net Loans and Deferred Premium and Loan Costs	<u><u>\$ 992,874,833</u></u>

All student loans are guaranteed as to principal and accrued interest. In order for the loans to be or remain guaranteed, certain due diligence requirements in loan servicing must be met. As of June 30, 2004, \$2,660,554 of student loans were no longer considered guaranteed due to violation of due diligence requirements.

The Corporation withholds certain origination fees from the loan disbursements on FFELP loans to the borrowers and remits these fees to USDE. The amount of the origination fees is based on a percentage of the gross loan amount.

The Corporation is also required to pay to USDE certain lender and rebate fees. The amount of the lender fees is based on a certain percentage of the gross loan amount on all FFELP loans originated after October 1, 1993, and a certain percentage of the carrying value of the Consolidation Loans.

Loan origination costs are capitalized when the loan is made and are amortized using the projected balances outstanding method, which approximates the effective interest method, over the estimated economic life of the loan. The capitalized loan origination costs, net of accumulated amortization, at June 30, 2004, were \$14,295,902.

Generally, student loans of the Corporation are pledged as collateral for the various obligations of the Corporation.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**7. Special Allowance**

The U.S. Department of Education pays a special allowance to the Corporation after the end of each quarter representing supplemental interest on outstanding insured loans. FFELP loans disbursed during the period from January 1, 2000, through June 30, 2004, receive special allowance at a rate based upon the average of the bond equivalent rates of the 3-month commercial paper rate as reported by the U.S. Federal Reserve. Other eligible loans receive special allowance based on the 91-day U.S. Treasury bill rates. Certain loans financed through bonds dated prior to October 1, 1993, receive a 9.5% minimum rate of return based on provisions of the Higher Education Act of 1965, as amended, and related interpretations by the USDE. Possible changes in legislation and/or USDE interpretations in the future could cause this benefit to be reduced or eliminated; however, management does not expect any such changes to be retroactive.

**8. Principal and Interest Forgiveness**

During fiscal year 2004, the Corporation forgave \$9,672,561 in loan principal and \$2,512,721 in accrued interest for certain borrowers who provided teaching and nursing service in the Commonwealth and students who completed the academic period for which their loan was made.

Interest is treated as a reduction to student loan revenue in the period of the award and forgiven student loan principal is recorded as an operating expense in the period of the award.

**9. Lease/Bond Payable**

On June 22, 2000, the Commonwealth of Kentucky State Property and Building Commission (the "Commission") issued \$8,825,000 in bonds payable on behalf of the Authority. The proceeds of the bonds are used to house the Authority's operations located in Frankfort, Kentucky. On October 8, 2003, the Commission issued additional bonds payable on behalf of the Authority as a partial refunding of original bonds payable.

The original bonds bear interest at fixed rates, which varies from 5.00% to 5.30% and has a final maturity date of May 1, 2010. The new bonds bear interest at fixed rates, which varies from 2.0% to 5.25% and has a maturity date of May 2020. The bonds are special and limited obligations of the Commission. The bonds do not constitute a debt, liability, or obligation of the Commonwealth of Kentucky or a pledge of the full faith and credit or taxing power of the Commonwealth of Kentucky, but are payable solely from amounts derived from the biennially renewable lease agreement with the Authority as described below. The bondholders have no security interest in any properties constituting the project or any amounts derived there from. The scheduled payment of principal and interest on the bonds are guaranteed under an insurance policy.

Continued

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**9. Lease/Bond Payable--Continued**

In connection with the issuance of the bonds, the Authority entered into a financing/lease agreement with the Commission whereby the Authority agreed to lease the newly constructed building. The lease is for an initial two-year term ending June 30, 2002, with the right to renew for nine additional two-year renewal periods.

The Authority can cancel the lease on the last business day in May immediately preceding the beginning of any renewal term. The lease payments are equal to the debt service required by the bond indenture. In connection with the agreements, the Commonwealth of Kentucky General Assembly appropriated sufficient spending authorization to the Authority to pay the lease payments required through June 30, 2004. There can be no assurance to make rent payments past the two-year lease period. The Authority did renew the lease for the biennium ending June 30, 2006.

A summary of the activity for the bond issues for the year ended June 30, 2004, is as follows:

	<u>June 30,</u> <u>2003</u>	<u>Additions</u>	<u>Payments</u>	<u>June 30,</u> <u>2004</u>
Bond Payable	<u>\$ 8,240,000</u>	<u>\$ 2,545,000</u>	<u>\$ 2,700,000</u>	<u>\$ 8,085,000</u>

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2004

9. Lease/Bond Payable--Continued

Debt service requirements for the next five fiscal years and thereafter are as follows:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>
2005	\$ 350,000	\$ 398,618
2006	365,000	381,554
2007	380,000	363,558
2008	400,000	344,569
2009	420,000	324,259
<u>Five Years Ending June 30,</u>		
2010 - 2014	2,410,000	1,311,372
2015 - 2019	3,050,000	667,878
2020	710,000	37,275
	<u>\$8,085,000</u>	<u>\$3,829,083</u>



Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2004

10. Revenue Bonds

The balance of revenue bonds at June 30, 2004, and the related activity for the year ended June 30, 2004 are as follows (in thousands)

Series	Scheduled Maturity	Interest Rate	June 30, 2003	Bond Maturities	New Issues	June 30, 2004
<b>1983 General Bond Resolution</b>						
1991 E	December 1, 2011	Weekly	\$ 46,000,000			\$ 46,000,000
1993 B	Semi-annually in various amounts through December 1, 2005	4.90% to 5.30%	55,800,000	\$ (18,880,000)		36,920,000
1996 A	June 1, 2026	Weekly**	25,000,000			25,000,000
2003 A	December 1, 2032	Every 35 Days	20,600,000			20,600,000
2003 B	June 1, 2005	1.65%	20,000,000			20,000,000
<b>1997 General Bond Resolution</b>						
1997 A-1	May 1, 2027	Every 35 days**	45,250,000			45,250,000
1997 A-2	May 1, 2027	Every 35 days**	45,200,000			45,200,000
1997 B	May 1, 2027	Every 35 days**	44,550,000			44,550,000
1998 A-1	May 1, 2028	Every 28 days**	36,400,000			36,400,000
1998 A-2	May 1, 2028	Every 28 days**	36,400,000			36,400,000
1998 B	May 1, 2028	Every 35 days**	42,200,000			42,200,000
1999 A	May 1, 2029	Every 28 days**	51,350,000			51,350,000
1999 B	May 1, 2029	Every 35 days**	23,650,000			23,650,000
2000 A-1	May 1, 2030	Every 28 days**	42,100,000			42,100,000
2000 A-2	May 1, 2030	Every 28 days**	42,100,000			42,100,000
2000 A-3	May 1, 2030	Every 35 days**	42,050,000			42,050,000
2000 B	May 1, 2030	Every 35 days**	23,750,000			23,750,000
2001 A-1	May 1, 2031	Every 35 days**	59,850,000			59,850,000
2001 A-2	May 1, 2031	Every 35 days**	59,850,000			59,850,000
2001 B	May 1, 2031	Every 35 days**	30,300,000			30,300,000
2002 A-1	May 1, 2032	Every 28 days**	55,450,000			55,450,000
2002 A-2	May 1, 2032	Every 35 days**	55,450,000			55,450,000
2002 A-3	May 1, 2032	Every 35 days**	39,100,000			39,100,000
2003 A-1	May 1, 2033	Every 35 days**	63,700,000			63,700,000
2003 A-2	May 1, 2033	Every 35 days**	16,950,000			16,950,000
			<u>\$1,023,050,000</u>	<u>\$ (18,880,000)</u>	<u>\$ -</u>	<u>\$ 1,004,170,000</u>

\*\* Variable interest rate changes based on specified indices.

Notes to Financial Statements--Continued

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**10. Revenue Bonds--Continued**

All Revenue Bonds are tax-exempt except for the Senior Series 1997 A-1 and 1997 A-2, Senior Series 1998 A-1 and 1998 A-2, Senior Series 1999 A, and Senior Series 2000 A-1, 2000 A-2, and Senior Series 2000 A-3 and Senior Series 2001 A-1 and 2001 A-2 and Senior Series 2002 A-1 and 2002 A-2.

Debt service requirements to maturity or redemption date, assuming interest rates on variable rate debt remains at June 30, 2004 levels, are as follows:

	<b>Principal Repayment Amount (Thousands)</b>		
	<b>83 GBR</b>	<b>97 GBR</b>	<b>Total</b>
Year Ending June 30, 2005	\$ 56,920		\$ 56,920
Year Ending June 30, 2006			
Year Ending June 30, 2007			
Year Ending June 30, 2008			
Year Ending June 30, 2009			
5 Years Ending June 30, 2014	46,000		46,000
5 Years Ending June 30, 2019			
5 Years Ending June 30, 2024			
5 Years Ending June 30, 2029	25,000	\$ 250,000	275,000
5 Years Ending June 30, 2034	20,600	605,650	626,250
	<u>\$ 148,520</u>	<u>\$ 855,650</u>	<u>\$ 1,004,170</u>

	<b>Interest Payments Amount (Thousands)</b>		
	<b>83 GBR</b>	<b>97 GBR</b>	<b>Total</b>
Year Ending June 30, 2005	\$ 1,682	\$ 17,272	\$ 18,954
Year Ending June 30, 2006	1,499	15,396	16,895
Year Ending June 30, 2007	1,499	15,396	16,895
Year Ending June 30, 2008	1,499	15,396	16,895
Year Ending June 30, 2009	1,499	15,396	16,895
5 Years Ending June 30, 2014	5,615	76,978	82,593
5 Years Ending June 30, 2019	3,732	76,978	80,710
5 Years Ending June 30, 2024	3,732	76,978	80,710
5 Years Ending June 30, 2029	2,471	69,085	71,556
5 Years Ending June 30, 2034	1,293	19,780	21,073
	<u>\$ 24,521</u>	<u>\$ 398,655</u>	<u>\$ 423,176</u>

All assets of the 1983 General Bond Resolution Fund and 1997 General Bond Resolution Fund are pledged for repayment of the specific bond issues under each resolution.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**11. Line of Credit**

The Corporation has Line of Credit Agreement with Bank of America, N.A., providing for advances to the Corporation not to exceed an aggregate outstanding principal balance of \$100 million. The borrowing period ends December 31, 2005, and can be extended at the discretion of both parties through December 31, 2006. During the year ended June 30, 2004, the Corporation drew down \$91,280,000 and made principal payments of \$50,000,000 on this line of credit. At June 30, 2004, there was \$41,280,000 outstanding.

**12. Allowance for Arbitrage Liabilities**

Certain of the Corporation's tax-exempt bond issues subject the Corporation to potential arbitrage liabilities under U.S. tax law. Arbitrage liabilities, under current federal income tax law regarding tax-exempt bond issues, consist of three types: (1) yield adjustment payments, (2) forgiveness and (3) arbitrage rebate. At June 30, 2004, the Corporation is reporting a liability for yield adjustment payments and forgiveness of \$20,308,540 and for arbitrage rebate of \$184,299.

The determination of excess yield on acquired purpose investments is cumulative over the life of the applicable bond series, as is the determination of arbitrage rebate on non-purpose investments, except for variable rate bonds for which arbitrage rebate is generally determined for each five-year period without retroactivity.

Yield adjustment payments, which also relate to yield restriction on acquired purpose investments, are applicable to the 1991 Series D & E Bonds, 1996 Series A, Subordinate Series 1997-B, Senior Series 1998B, Senior Series 1999B, Senior Series 2000B, Senior Series 2001B, and any future issues except certain refunding issues. The allowable yield is 2% above the bond yield (arbitrage yield), with the federal special allowance included in income. The loss of tax-exempt status may be avoided by rebating the excess yield to the U.S. Treasury every 10 years, and upon final maturity of the bonds.

Forgiveness is applicable to the 1991 Series B & C; 1993 Series A, B & C; 1994 Series A & B; 1995 Series A, B & C; 1996 Series B; and 1997 Series A, B, C, & D bonds. In general, a yield restriction is imposed on acquired purpose investments, designating the allowable yield as 1.5% or 2.0% above the bond yield (arbitrage yield). The loss of tax-exempt status may be avoided by partial forgiveness of the applicable student loans. Forgiveness can be applied upon maturity of the bonds or as otherwise prescribed by the bond resolutions.

Arbitrage rebate is applicable to all of the Corporation's tax-exempt bonds except the 1985 Series A. With certain limited exceptions, income earned on non-purpose investments (investments other than student loans) which exceeds the bond yield (arbitrage yield), must be rebated to the U.S. Treasury. Payments of at least 90% are due every five years after the year of issuance and upon final maturity of bonds.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**13. Credit and Liquidity Facilities and Bond Remarketing**

The 1991 Series E and 1996 A Bonds are collateralized with Standby Bond Purchase Agreements, pursuant to which Landesbank Hessen-Thüringen Girozentrale will purchase any bonds not remarketed. The 1991 Series E Bonds and the 1996 Series A Bonds also have a Municipal Bond Insurance Policy issued by AMBAC Indemnity Corporation and MBIA Insurance Corporation, respectively, which collateralizes payment of principal and interest on the bonds. The Standby Bond Purchase Agreements expires December 1, 2011, for the 1991 Series E Bonds and December 31, 2015, for the 1996 A Bonds. Unless it is renewed, the AMBAC Municipal Bond Insurance Policy extends through the term of the 1991 Series E Bonds, December 1, 2011, and the MBIA Municipal Bond Insurance Policy extends through the term of the 1996 Series A Bonds, June 1, 2026.

The Corporation pays certain fees with respect to its variable rate bonds to auction agents, broker dealers, market agents, remarketing agents, and tender agents for remarketing bonds or conducting auctions of bonds. These arrangements are generally cancelable with prior notice by either party.

**14. Retirement Plans**

The Commonwealth of Kentucky provides retirement benefits to all of the Authorities eligible full-time employees through the Kentucky Employees Retirement System (KERS). KERS is a cost-sharing multiple employer defined benefit plan sponsored by the Commonwealth of Kentucky, which provides retirement, disability, and death benefits. The employees contributed 5% of the gross wages to the plan. Subsequent to June 30, 2004, this rate was increased to 10.29%. The Authority contributed 5.89% in 2004. Such rates were intended to provide for normal costs on a current basis, plus an amount equal to the amortization of past service costs over 30 years, using the level percentage of payroll method. These rates are determined by the Board of Trustees of the Kentucky Retirement System each biennium. The payroll of employees covered by a retirement plan was approximately \$16,975,000 (which approximates total payroll) for the year ended June 30, 2004. KERS participants have a fully invested interest after completion of 60 months service, 12 months of which are current service. The KERS contribution requirement for the year ended June 30, 2004, was approximately \$1,767,080, which consisted of \$955,711 in Authority contributions and \$811,369 from employees. The Authority's contributions to KERS for the years ended June 30, 2003 and 2002 were \$629,009 and \$683,474, respectively.

Until June 30, 1994, Teachers Insurance and Annuity Association (TIAA) was offered to eligible employees. TIAA was terminated as of June 30, 1994, and all TIAA participants became covered by KERS effective July 1, 1994. In order to provide coverage equivalent with KERS participants to the Authority's employees who were former TIAA participants regarding retirees' health insurance premiums, the Authority established an allowance for retirees' insurance based on management's projected estimate of future requirements. The portion of retirees' premiums paid by KERS is based on years of service under KERS; the allowance provides for the Authority to fund a portion of premiums, which will result in the same coverage for the 5 employees covered. Plan assets and the accrued liability for the postretirement healthcare plan totaled \$658,518 at June 30, 2004.

**Kentucky Higher Education Assistance Authority**

June 30, 2004

**15. Note Payable**

The Plan has an interest-free note payable to the Commonwealth of Kentucky Unclaimed Property Fund in the amount of \$1 million. The Plan paid \$100,000 of principal on the note during the fiscal year ended June 30, 2004. The remaining \$900,000 of principal is due in fiscal year 2005.

**16. Tuition Benefit Payable**

The following assumptions developed by management were used in the actuarial valuation as of June 30, 2004. These assumptions are based on historical data for both state and national trends.

**Investment Rates:** The investment yield assumption is based on estimates of the yields that will be available on the investment portfolio and cash and cash equivalents. Since inception, the investment yield assumption has been 7.76% per annum.

**Investment Expenses:** The investment expense assumption is based on a sliding scale of costs related to total assets. The investment expense is projected as .49% of the first \$25 million, .28% of the next \$25 million, and .21 % of assets in excess of \$50 million.

**Tuition Increases:** Tuition increases are based on the current best estimate of future tuition increases for Kentucky's public vocational schools, colleges, and universities. For the period from inception to June 30, 2003, the assumption for tuition increases had been 6.5%. On July 1, 2003, the tuition increase assumption was adjusted to 7.5% annually.

The tuition increase assumption remains at 7.5% annually through year ending June 30, 2011, and 7.00% annually thereafter. For the period from inception to June 30, 2004, the annualized tuition increase for the highest-priced Kentucky public university, relative to the KAPT Standard Plan, which represents 92% of KAPT enrollments, has been 9.1%. For the Kentucky Community and Technical College System, relative to the KAPT Value Plan, the average annualized tuition increase from inception to June 30, 2004, has been 15.7%. For the University of Kentucky, relative to the KAPT Premium Plan, the average annualized tuition increase from inception to June 30, 2004, has been 9.73%.

**Payment of Tuition and Mandatory Fees:** Payments of tuition and mandatory fees are assumed to be 32 credit hours per year of utilization and payments occur twice annually.



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**17. Restricted Net Assets**

- a. **Federal Student Loan Reserve Fund:** Net assets are restricted for certain FFELP activities, primarily the payments of claims.
- b. **Agency Operating Fund:** Net assets are restricted for certain FFELP activities and other student aid activities.
- c. **Education Finance Funds:** Net assets are restricted as required by the 1983 and 1997 General Bond Resolutions, the separate Series Resolutions, and Line of Credit Agreements.
- d. **Student Aid Funds:** The Student Aid net assets are restricted for the Student Aid Programs.

**18. Operating Leases**

The Corporation leases office space and equipment under agreements expiring through 2009. The following are the approximate minimum lease commitments under operating leases:

Year Ending June 30,	
2005	\$ 775,000
2006	789,000
2007	714,000
2008	212,000
2009	194,000

**19. Commitments and Contingencies**

The Corporation has entered into loan purchase contracts with various eligible lenders. Subject to the terms and conditions of these agreements, the Corporation on June 30, 2004, had plans to purchase approximately \$49.5 million of loans. These contracts cannot be terminated by either party.

Continued



**Kentucky Higher Education Assistance Authority**

June 30, 2004

**19. Commitments and Contingencies--Continued**

The FSLRF, a fiduciary fund maintained on behalf of the USDE, is contingently liable for loans made by financial institutions that qualify for guaranty. The default ratio for loans guaranteed by the Authority is below 5% for the fiscal year ended June 30, 2004. As a result, the federal government's reinsurance rate for defaults for the fiscal year ended June 30, 2004, is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1993 to September 30, 1998. In the event of future adverse default experience, the Authority could be liable for up to 25% of defaulted loans. At the beginning of each fiscal year, the Authority's reinsurance rate returns to 98%; management does not expect that all guaranteed loans could default in one year.

For loans made on or after October 1, 1998, the reinsurance rate will be 95%. In the event of future adverse default experience, the Authority could be liable for up to 25% of such defaulted loans.

While management believes the FSLRF's expected maximum contingent liability is less than 25% of outstanding guaranteed loans, the maximum contingent liability at June 30, 2004 is calculated as follows:

Amount of guaranteed student loans outstanding at lenders	\$ 2,908,356,000
Less minimum federal government share - 75%	<u>2,181,267,000</u>
	<u>\$ 727,089,000</u>

**20. Subsequent Event**

The 2004 Kentucky General Assembly did not pass a biennial budget for the executive branch of government, which resulted in governing control of the Plan program being transferred from the Authority's Board of Directors to a separate board of directors effective July 1, 2004.

On August 10, 2004, the Corporation issued \$350,000,000 of Student Loan Revenue Bonds to continue its student loan finance program. The \$202,600,000 2004 Series A & B Tax Exempt Bonds are scheduled to mature on June 1, 2034, and bear interest rates that change every 35 days based on specified indices. The \$147,400,000 2004 Series A Taxable Bonds are scheduled to mature on June 1, 2034, and bear interest rates that change every 28 days based on specified indices.